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CRITICAL ISSUES IN NEPAL'S MICRO-FINANCE CIRCUMSTANCES

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and

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TABLE OF CONTENTS

Acronyms and Abbreviations

ADBN	=	Agriculture Development Bank, Nepal
AsDB or ADB	=	Asian Development Bank
AMSL	=	Above Mean Sea Level
CECI	=	Canadian Centre for International Studies and Cooperation
CGAP	=	Consultative Group to Assist the Poorest
CIDR	=	Centre for International Development and Research
CMRLF	=	Community Managed Revolving Loan Fund
CPI	=	Consumer Price Index
CSD	=	Centre for Self Help Development
CVECA	=	Caisses Villageoises d'Epargne et de Crédit Autogérées
DEPROSC	=	Development Project Service Centre
FAO	=	Food and Agricultural Organization
FINCA	=	Foundation for International Community Assistance
GB	=	Grameen Bank
GBB	=	Grameen Bikas Bank
GBR	=	Grameen Bank Replicator
GDP	=	Gross Domestic Product
GNP	=	Gross National Product
GO	=	Group Organizer
Ha.	=	Hectare
HMG	=	His Majesty's Government of Nepal
IBP	=	Intensive Banking Program
IDP	=	Institution Development Program
IFAD	=	International Fund for Agricultural Development
INGOs	=	International Non Government Organizations
IRIS	=	Institutional Reform and the Informal Sector
MCPW	=	Micro Credit Project for Women
MLD	=	Ministry of Local Development
NBL	=	Nepal Bank Limited
NEFSCUN	=	Nepal Federation of Savings and Credit Cooperative Unions
NGOs	=	Non Government Organizations
NPC	=	National Planning Commission
NRB	=	Nepal Rastra Bank
PACT	=	Private Agencies Collaborating Together
PCRW	=	Production Credit for Rural Women
RSRF	=	Rural Self Reliance Fund
RBB	=	Rastriya Banijya Bank
RRDB	=	Regional Rural Development Bank
Rs.	=	Rupees
SCCs	=	Savings and Credit Cooperatives
SDI	=	Subsidy Dependency Index
SFCLs	=	Small Farmers' Cooperative Limited
SFDP	=	Small Farmers' Development Program
UNICEF	=	United Nations Children Fund
USA	=	United States of America
USAID	=	United States Agency for International Development
UNDP	=	United Nations Development Program
VDCs	=	Village Development Committees
WDD	=	Women Development Division

Executive Summary

This study examines the effectiveness and outreach of microfinance organizations in Nepal, leading to the identification of critical issues currently faced by these organizations. An overall assessment of microfinance organizations in Nepal is presented, followed by a summary of the critical issues. Solutions to these issues are proposed and specific recommendations for government, donors, and microfinance practitioners are provided.

Nepal's extreme level of poverty and difficult geographic circumstances make the delivery of financial services to the poor particularly challenging. Limited economic opportunities and minimal arable land result in low incomes and reduced savings capacity. Women in Nepal are significantly poorer than men, have little access to education and have less control over economic decisions. They are predominately confined to domestic and agricultural activities and have few economic opportunities, working mostly as semi-skilled or unskilled general wage workers. Providing access to credit and savings services has proven to contribute towards poverty alleviation and the empowerment of women. However, this must be done in a sustainable and efficient manner, ensuring continued access to financial services over the long-term.

The findings of this study show that in general terms, microfinance organizations in Nepal appreciate the costs and benefits associated with microfinance. However, outreach is limited, particularly in the remote hill areas, and financial management is poor, leading to microfinance institutions which are largely unsustainable over the longer term. The microfinance sector in Nepal is characterized by a social service approach rather than a business approach. Continued reference to microfinance clients as beneficiaries is characteristic of a 'social banking' approach rather than sustainable 'client focused' financial intermediation. Ultimately microfinance organizations in Nepal will have to adopt an approach focused on providing valued services to 'clients' rather than treating them as beneficiaries who require hand-outs and subsidies. This is not to suggest that 'social intermediation' services are not required. The authors believe that social intermediation is an integral component of the provision of effective microfinance services in South Asia. However, this paper specifically addresses financial intermediation and suggests that social service delivery should not be mixed with the delivery of financial services. Further, it suggests that all microfinance activities should be designed to meet the need of the clients, i.e. be demand-driven rather than supply-driven, taking into account the particular needs of women.

Critical issues identified in this study are:

1. financial viability of microfinance institutions including financial self-sufficiency, financial reporting and subsidies;
2. transformation of government programs from retail banking to wholesale banking;
3. expansion of the provision of financial services to the Hills;
4. encroachment or unfair competition between microfinance institutions;
5. lack of appropriate institutional structures and the inability to form a federation of microfinance institutions.

Microfinance programs initiated by the government in Nepal are generally inefficient and financially unsustainable, with the exception of government Grameen Bank replications (Grameen Bikas Banks.) Non-governmental Organizations (NGOs) and Savings and Credit Cooperatives (SCCs) supported by INGOs are for the most part more efficient than government initiatives, but are also generally unsustainable owing to low interest rates on loans and the mixing of financial and social services. The most sustainable microfinance programs in Nepal are indigenous NGOs/SCCs that receive no external funding. However, these organizations are very limited in their outreach and lack access to capital funding. In addition, their lack of external exposure makes innovation, documentation, and resistance to existing social power structures problematic.

We suggest that the government transform its retail lending programs to providing wholesale loans to sustainable microfinance institutions, and that donors and INGOs support only those institutions moving towards achieving financial sustainability. In addition, interest rates should be at least as high as market rates and possibly higher. Capital funds and training to enable sufficient bookkeeping and membership growth should be made available to NGOs/SCCs that are operating in the more remote areas of Nepal.

Financial reporting of microfinance activities in Nepal is better than in many South Asian countries, because microfinance organizations in Nepal take into consideration the financial and operating costs of financial intermediation. However, little attention is paid to accurately assessing loan losses and the corresponding reduced interest revenue. Improvements in the financial reporting of microfinance institutions in Nepal are required, including: separating financial intermediation activities from other activities; accurate assessment and recording of loan losses; and the replacement of reported repayment rates and cumulative loan disbursements with portfolio at risk and current loans outstanding, respectively.

A number of subsidies are provided to microfinance institutions in Nepal, including subsidized capital for onlending, technical assistance, and government interest rate subsidies to borrowers. For the most part, these subsidies are considered necessary for the development of sustainable financial and social intermediation, particularly for organizations working in remote areas. However, interest rate subsidies are ineffective, distort the market and should be eliminated. Subsidies should only be provided for capacity building of institutions, developing organizational capabilities of groups, and in isolated circumstances, for initial capital funds for onlending.

Expansion of the provision of financial services to the Hills is required. It is suggested that the government and donors support the development of local NGOs/SCCs in the Hill areas using village banking models designed in Latin America and West Africa, and community loan funds. The Grameens have also proposed modifications such as subcontracting local individuals for service provision, and this type of experimentation can be encouraged. Continued support may be required to provide incentives for organizations to work in remote areas. This support could be in the form of cost-sharing schemes, skills training, and/or the provision of capital funds.

Most microfinance organizations in Nepal concentrate their services in the Terai (lowlands) area. This has lead to the duplication of services and claims of ‘encroachment’ from some institutions, particularly in light of the subsidies accepted on behalf of some borrowers (government programs) and not others. Field visits indicate that encroachment to date is small and localized in the eastern Terai. It is suggested that a central information mechanism be established to enable credit organizations to share names of borrowers or villages accessing services from each microfinance institution. In addition, once interest rate subsidies are removed and as each institution clearly defines the target market and designs its services accordingly, encroachment should no longer be an issue. This study includes a VDC-wise table of micro-finance service providers as the start of such information-sharing.

The lack of an appropriate institutional structure for microfinance organizations in Nepal and the inability of cooperatives to form more than one federation are seen as impediments to effective financial intermediation for the poor. Legal reforms are required to establish an institutional structure that takes into account the needs and characteristics of microfinance institutions and to enable cooperatives and NGOs to form federations freely, and according to their specific needs.

1. Introduction and Contextual Background[1]

1.1 INTRODUCTION

Nepal has developed a considerable history in microfinance activities. The official policy recognition of the importance of this sector in poverty alleviation came in the Sixth Plan (1980/1 - 1984/5.) Programs to ensure that the poor, and particularly poor women who traditionally have not had access to formal credit, acquire it have been developed and implemented by both government and non-governmental institutions.

Since 1991 the momentum in this sector has increased considerably, resulting in the emergence of various issues potentially hindering the successful long-term provision of financial services to the poor. This has led His Majesty's Government (HMG), supported by USAID, to seek proposed solutions and recommendations for the continued and expanded provision of microfinance in Nepal. In particular, it is necessary to identify which models work best for both expansion and sustainable provision of microfinance services to those who need it most -- rural poor women. The critical issues identified include:

1. financial viability of microfinance institutions, including financial self-sufficiency, financial reporting and subsidies;
2. transformation of government programs from retail banking to wholesale banking;
3. expansion of the provision of financial services to the Hills;
4. encroachment or unfair competition between microfinance institutions;
5. lack of appropriate institutional structures and the inability to form a federation of microfinance institutions.

This study examines the current circumstances of microfinance in Nepal, assesses the critical issues, and provides recommendations to improve the efficiency and effectiveness of the microfinance sector.

1.1.1 Objectives

The specific objectives of this study are to:

- review the circumstances regarding current microfinance activities and create a 'snapshot' of the microfinance situation;
- identify and confirm critical issues in microfinance in Nepal; and
- suggest means of creating favorable conditions to support both expansion to poor

[1] This study was carried out by the Development Project Service Center (DEPROSC-NEPAL) and Joanna Ledgerwood, of Micro Finance International, Canada, under USAID/Nepal funding through the IRIS Project.

groups not currently served (particularly women), and mechanisms to improve the long-term sustainability of microfinance institutions.

1.1.2 Methodology

Data for this study were obtained both from secondary and primary sources. Secondary sources of information included papers and statistics (both published and unpublished) related to microfinance activities. Primary data was obtained through field surveys in various selected sites and through interviews with personnel of the major microfinance institutions in Nepal and relevant government officials and policy-makers.

Field surveys were conducted in 13 different districts.[2] During the field surveys, information was gathered through focus group discussions and observations of the consultant(s.) As part of the field surveys, case studies of selected programs were prepared documenting specific activities and methodologies leading to success/failure, financial and institutional viability, competitive forces, growth/service delivery issues, etc. The case studies are included in Annex 2 and were used to support specific findings.

1.1.3 Report Organization

This report is divided into four chapters including: Introduction and Contextual Background; Review of Current Microfinance Activities and Critical Issues; Proposed Solutions; and Recommendations.

1.2 CONTEXTUAL BACKGROUND

Nepal is one of the least developed countries of the world, characterized by its land-locked position and the extremes of its physiographic and ecological features. With an estimated population of 22 million, the country is divided into three parallel regions, each with its own distinctive environment, peoples, economy, customs, and culture.

1.2.1 Geography

The Terai lies in the southernmost part of the country, averaging only 20 km in width and covering about 23% of Nepal's total land area. The Terai contains virtually all of the best farmland in Nepal and supports nearly half the population. Seventy percent of the country's arable land is in the Terai and over 60% of its grain is grown there.[3]

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[2] Districts included Bhojpur, Morang, Siraha, Sapteri, Udayapur, Rautahat, Chitwan, Gorkha, Lamjung, Nawalparasi, Banke, Surkhet, Kailali and Dadeldhura.

[3] Moran, Kerry. Nepal Handbook Second Edition. Moon Publications, Inc. California, USA. 1996. p.6

Because this area is relatively densely populated, has good transportation services, and contains the majority of arable land, the Terai is most conducive for the provision of microfinance services. Hence, most microfinance activities in Nepal are concentrated in this area.

The Hills cover nearly 42% of Nepal and contain about 45% of the population. The Hills area consists of valleys between the Mahabharat Lekh and Great Himalaya Mountains. Terraced ridges carved out by generations of farmers result in many marginal sized farms, providing small amounts of food. Very limited infrastructure and access to markets as well as little arable land make the provision of microfinance services in the Hills area very difficult. The level of poverty in the hills is greater than in the Terai, resulting in reduced economic activity and opportunities.

The Mountains cover nearly 35% of Nepal's land, with altitudes above 3,000 meters above sea level. This area contains eight of the world's 10 highest mountains and is characterized by its cold climate and snow cover for most parts of the year. Less than eight percent of Nepal's population lives in this region, and little agricultural activity takes place. Most families in the western Hill and Mountain districts produce enough food for only six or seven months of the year, and must forage to supplement their diet during the lean months. This often results in poor families falling into a cycle of debt and exploitation that can continue through generations. The Mountain region is the most difficult area to provide microfinance due to its remoteness and sparse population.

Nepal's population doubled between 1951 and 1983 and is expected to double again in 30 years, further accelerating the destruction of its ecosystem. In the Hills, every available piece of land is already cultivated. However, growing families and shrinking land plots leave the people no choice but to extend their holdings onto land better left unplowed, to graze their animals on steep slopes, and to cut down forests. This results in frequent landslides, silted rivers, and barren hills furrowed by deep gullies, manifested by lower crop yields, fewer proximate water sources, and longer walks to cut firewood and fodder. This inhibits economic opportunities for Nepalis by reducing both the time and resources available for activities other than survival. Any provision of financial services must consider these trends.

1.2.2 Administration

Administratively, Nepal is divided into 5 development regions, 14 zones, 75 districts, 3995 village development committees (VDCs) and 36 municipalities. Each VDC and municipality are further divided into nine wards. Within the regions, the east and center have had the most development attention and interventions, while the west -- and particularly the far west -- are the most disadvantaged in terms of infrastructure, human investment, and economic development. Microfinance services may have the most impact therefore in the east and central regions, but may also accelerate a deepening disparity between the east and western regions.

1.2.3 Poverty Status

According to The World Development Report (1996), Nepal is the eleventh poorest country in the world. The National Planning Commission (NPC) states that 42% of the population failed to meet the minimum amenities of life in 1996. Of these, about one third are believed to be ultra poor.[4] The recent poverty survey which the Central Bureau of Statistics undertook with World Bank support confirms these figures.

Table 1.1 below highlights economic figures for Nepal relative to other South Asian countries (and China.)

Table 1.1 Economic Indicators

	Nepal	Sri Lanka	China	Pakistan	India	Myan-mar	Bhutan	Bangla-desh
Life expectancy	**54**	72	71	62	61	59	49	56
Adult literacy	**27%**	90%	N/A	38%	N/A	83%	N/A	38%
GDP growth	**2.3%**	5.6%	9.8%	6.1%	7.0%	7.7%	5.5%	4.7%
Per-cap GDP	**$1,165**	$3,415	$2,935	$2,340	$1,385	$753	$1,475	$1,410
Per-cap GNP	**$210**	$660	$540	$465	$335	$890	$415	$283
Pop growth	**2.3%**	1.2%	1.2%	2.9%	2.1%	2.1%	2.3%	2.2%
Inflation CPI	**7.6%**	19.9%	7.0%	10.3%	8.3%	12.1%	8.6%	2.5%
Foreign Debt	**$1.9b**	$6.4b	$106.6b	$26.1b	$85.2b	$5.3b	$0.1b	$14.8b
Calorie intake	**2,246**	2,286	2,703	2,377	2,243	2,598	2,058	2,100

Source: Asiaweek, January 10, 1997, p. 72 (latest figures available from national and multilateral sources) and the World Bank

Nepal is predominately agrarian, with 81% of the population dependent on agriculture and 42% of the total national Gross Domestic Product (GDP) contributed by this sector (World Bank.) Most Nepalis are subsistence farmers, managing to grow enough to feed their families and sell a small surplus, which buys a few necessities like salt, tea, and cloth. Rice, maize, mustard and wheat are grown in the lower elevations and millet, barley and potatoes in the higher elevations. The minimal size of land holdings is a major aspect of rural poverty in Nepal, as land represents the major productive resource in rural areas. "Over 50% of all landholding is below 0.5 ha. which together accounts for about 6.6% of total cultivated area,

[4] "Small Farmer Development Program Two Decades of Crusade Against Poverty, Volume 1," Small Farmer Development Centre, Agricultural Development Bank, Nepal, July 1996.

while the top four percent of the population controls nearly half the total land. Reliable estimates put the percentage of landless at 5-10% in the hills and 15-20% in the Terai."[5] With limited land, people turn to livestock, foraging, sale of labor on a daily basis according to demand, and trade to supplement their incomes.

The extreme level of poverty in Nepal affects the provision and use of microfinance. Loan sizes tend to be small, collateral is scarce or unavailable, and savings capacity is limited.

[5] Ibid., p.4.

> "The rate of gross savings by rural households is estimated at seven percent. Among the three regions, the average savings rate is the highest in the Terai and the Mountains (8%) and the lowest in the Hills (7%), mainly due to a large number of cases of negative savings by the marginal and landless households in the latter. The rural economy is thus caught by the stranglehold of low income, low savings and low investment. The infusion of credit can be a major key to breaking this stranglehold."[6]

1.2.4 Women's Economic Empowerment[7]

Microfinance programs are currently being promoted as a key strategy for simultaneously addressing both poverty alleviation and women's empowerment. Women make up 52% of Nepal's population and have a life expectancy of 53.4 years (1991 figures), making Nepal one of only three countries in the world where females' life expectancy is lower than that of males. UNICEF(1996) estimates less than 18% of Nepali women are literate. Women work on average 3-4 hours more per day than males, but their land holdings are marginal, and income levels and formal labor force participation are 20% lower than that of males. Women are predominately confined to agriculture, account for the majority of unpaid family workers, and are heavily concentrated in low-paid jobs. The aggregate data depict women's contribution to be heavily focused: 86% of all domestic work and 57% of subsistence agricultural activities. Women work mostly as semi-skilled or unskilled general wage workers. Less than 5% of civil servants, elected leaders, or judiciary are female. In addition, women in Nepal cannot inherit property, have little access to education, information or credit and have less control than males in their households over economic decisions.

Providing immediate and sustained assistance to women in the field of small and micro-enterprises and microfinance is a key factor to facilitate economic upliftment and the empowerment of women.

Where financial service provision leads to the setting up or expansion of micro-enterprises, there are a range of potential impacts including:[8]

- increasing women's income levels and control over income leading to greater levels of economic independence;

- access to networks and markets giving wider experience of the world outside the home,

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[6] Asian Development Bank, Manila. Nepal Rastra Bank, Kathmandu. Nepal Rural Credit Review Final Report Volume 1 (Summary Report), December 1994, p. 9.

[7] Most of this section is taken from Wilkinson, Betty: "IRIS/Nepal: Women's Economic Empowerment" 1996.

[8] Mayoux, Linda. "The Magic Ingredient? - Microfinance & Women's Empowerment" A Briefing Paper prepared for the Micro Credit Summit, Washington, February 1997.

increased access to information, and greater possibilities for development of other social and political roles;

- enhancing perceptions of women's contribution to household income and family welfare, increasing women's participation in household decisions about expenditure and other issues and leading to greater expenditure on women's welfare;
- more general improvements in attitudes to women's role in the household and community.

1.2.5 Development Problems and Constraints

Nepal faces considerable development problems and challenges. Agricultural productivity is low and declining due to population pressure on marginal lands. Nepal's limited resource base, rapid population growth, environmental degradation, low levels of social development and widespread poverty reinforce the development challenge. The ability to expand cultivable land for sustainable crop production, often at the cost of forest resources, is rapidly diminishing.

Opportunities in the non-agricultural sector remain largely unexploited due to lack of resources. In particular, access to financial services is limited, specifically for women. Access to financial services is further hindered by geographic limitations in the Hills and Mountain regions. Improvements in infrastructure, markets, communication facilities and skills training are also required. In short, Nepal requires a better enabling environment for business activities characterized by ease of access to markets, information, and financial services. This would increase the benefits of microfinance services, allowing microentrepreneurs, particularly women, to improve their economic positions.

2. Review of Current Microfinance Activities and Critical Issues

This chapter provides a review of current microfinance activities[9] in Nepal leading to the identification of critical issues. A brief discussion of the informal financial sector is provided, followed by an overview of the formal financial sector as it pertains to microfinance. The main discussion focuses on government-initiated microfinance programs and the semi-formal financial sector, including Non-Governmental Organizations (NGOs) and Savings and Credit Cooperatives (SCCs.)

2.1 THE INFORMAL FINANCIAL SECTOR

[9] Microfinance, in general terms, is the provision of very small loans, often without collateral, usually not greater than Rs 30,000 to people with minimal income and assets, and less than 1 hectare of land; and the collection of very small amounts of savings, usually on a compulsory basis but not exclusively.

Informal lenders in Nepal can be individual lenders such as landlords, merchants, farmer-lenders, goldsmiths, pawn brokers, friends, and relatives. Group informal institutions include dhikuti, dharam bhakari, and guthi. Informal lenders provide credit without procedural complexities, and have flexibility regarding repayments and collateral which does not exist in the formal sector. "The proportion of households reporting borrowing during the reference year from informal sources, such as money-lenders, friends and relatives, is estimated at 34 percent."[10] This rate is over 70% in the recent CBS/World Bank study.

Moneylenders exist in most villages and are also often significant landholders. They tend to lend either with gold or silver as collateral, or without collateral but with some implicit arrangement for crop production, labor services, or land as security. The interest charged by money lenders is generally very high, starting at 36% per annum and occasionally exceeding 100% per annum. In addition, they often receive either labor services or other small gifts as part of the request for the loans. As a result, loans from money lenders are generally used for emergency purposes such as medical crises or socio-cultural obligations such as weddings and funerals.

Traditional rotating credit groups such as dhikuties, dharam, bhakari, guthies, etc. are well established and widespread in Nepal; they represent a truly local and indigenous response to credit needs. Savings mobilized and credit delivered through informal rotating credit mechanisms like dhikuties represent an enormous level of financial activity, which provides some indication of the resources yet untapped by the formal and semi-formal sectors.[11] However, their successes and failures have not been well-documented in a formal sense.

Dhikuties are groups formed within villages for the purposes of savings and credit activities. Members are mainly businessmen, though in Pokhara and Mustang women sometimes participate. They are particularly popular amongst Nepal's ethnic trading communities, (e.g. the Thakali) or in urban areas such as the Kathmandu Valley. They are based upon the collection of equal amounts of savings collected each month (or other period) which are then lent out to each member in a rotating sequence. The rotation is generally determined by a bidding process where the bid with the highest interest rate receives the loan. Dhikuties have an average membership of 20 to 30 people with individual savings amounts ranging from Rs. 100 to Rs. 1,000.[12] At the end of the rotation, the surplus from interest paid is distributed equally to the members. The main risks are that those who borrow will not repay principal or interest due to business setbacks, or that a contributing member will drop out once he or she has received the

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[10] Asian Development Bank, Manila. Nepal Rastra Bank, Kathmandu. Nepal Rural Credit Review Final Report Volume 1 (Summary Report), December 1994.

[11] Centre Canadien d'Etude et de Cooperation Internationale "Community Based Savings and Credit Organizations in Nepal: Current Status and Future Prospects." Funded by the Ford Foundation. January 1996.

[12] Ibid.

group collection.

Dharam bhakari (literally, “welfare storage”) are group grain associations. Each member provides an equal contribution of grain at harvest. He may then “borrow” it in the off-season,

repaying at rates between 1.25 and 1.5 times the borrowed amount at the next harvest. These exist among small to medium farmers, and are a good safeguard against starvation.

Guthi are cultural heritage associations, common amongst the Newari and some tribal groups. They are like dhikuti in their form of standard collections of amounts from the groups, but accumulated funds are largely used for funerals or community welfare activities such as festivals. The group decides whether the user pays interest or not on the funds, and whether they are a loan or grant, based on the relative wealth and situation of the person requesting funds.

2.2 THE FORMAL FINANCIAL SECTOR

The formal financial sector in Nepal include the following institutions: the Central Bank (Nepal Rastra Bank); the Agricultural Development Bank (ADB/N); two government-owned commercial banks (the Nepal Bank Ltd. (NBL)[13] and the Rastriya Banijya Bank (RBB)), ten commercial banks, five government-owned Grameen Bikas banks (one each in five development regions of Nepal, based on the Grameen model, discussed below), five insurance companies and over 35 finance companies.

Most activities in the formal financial sector are commercial in nature, resulting in large loan sizes concentrated in industrial productive activities. The vast majority of loans are made to men, as women are not normally involved in larger businesses. “The proportion of rural households reporting borrowing from the formal or institutional sources during 1991/92 is estimated at a low of eight percent. Across regions, the proportions are four percent, eight percent and nine percent for the Mountains, the Hills and the Terai regions respectively.”[14]

Formal sector government financial institutions provide microfinance services only through mandated government programs. Each of these formal financial sector institutions implements government microfinance programs, often with assistance and funding from international donors. The following briefly describes each of these institutions and identifies the government microfinance programs with which each is

[13] The NBL has just become a majority private bank following the flotation of 10% of its shares to the employees (5%) and as a block sale.

[14] Asian Development Bank, Manila, Nepal Rastra Bank, Kathmandu, Nepal Rural Credit Review Final Report Volume 1 (Summary Report), December 1994, p.10.

involved. A full description of the microfinance programs is provided in the next section under Government-Initiated Microfinance Programs and the Semi-Formal Financial Sector.

The Nepal Rastra Bank (NRB) was established in 1956 and is Nepal's central bank. It is responsible for regulating and supervising the country's formal financial sector. In addition, NRB provides capital to NGOs and RRDBs for onlending through the Rural Self-Reliance Fund. The NRB also mandates commercial banks to lend directly to microentrepreneurs through the Intensive Banking Program. Under NRB mandate, up to 12% of the loan portfolio of any commercial bank must be lent to priority sector borrowers. Of this 12%, up to 3% must be lent either directly or indirectly as micro-credits.

The Agricultural Development Bank of Nepal (ADB/N) was formed in 1968 from the existing Cooperative Bank. It is wholly owned by the government and is the sole financial institution in Nepal specializing in agricultural and rural credit. The ADB/N began collecting deposits in the mid 1980s. The ADB/N operates the Small Farmer's Development Program and the Institutional Development Program.

The Nepal Bank Ltd (NBL) was formed in 1937 as a privately owned commercial bank. In the mid 1950's, the NBL was converted into a semi-government institution with the majority of shares held by HMG (51%.)   This was followed by the establishment of the Rastriya Banijya Bank (RBB), a fully-owned government bank, in 1963. These two state-owned commercial banks have a large urban branch network and control over two-thirds of the total deposits mobilized in the country. Their loans are primarily short term in nature, and the smaller ones are mostly for trade credit or social obligations, provided against the hypothecation of gold and silver. These two banks participate in the Intensive Banking Program of the NRB and provide micro-loans to clients of the Production Credit for Rural Women project.

In 1992, HMG established two Regional Rural Development Banks (RRDB), or Grameen Bikas Banks (GBBs), to provide financial services to the rural poor. Two more RRDBs were opened in 1995 and a fifth began operations in late 1996. These banks are based on the Grameen Bank model of Bangladesh and provide credit and savings services to low-income women. The Banks each have paid-up capital of Rs 60 million provided by HMG and the Nepal Rastra Bank (75%) and by selected commercial banks (25%.) The commercial banks can count this investment and any loans to the RRDBs against their deprived sector lending requirements.

2.3 GOVERNMENT-INITIATED MICROFINANCE PROGRAMS AND THE SEMI-FORMAL SECTOR

In addition to government-initiated microfinance programs in the formal sector, the semi-formal financial sector provides microfinance services through NGOs and SCCs.

The semi-formal financial sector is described as such because NGOs and SCCs are sometimes registered entities, but are not regulated nor supervised like formal financial sector institutions.

It is difficult to offer a generalization of the different microfinance models in Nepal as there is substantial overlap of government[15] and non-government programs. However, it is possible to loosely classify them into four models based on their organizational structure. The four models are:

i. government-mandated models implemented through commercial banks and government line agencies;

ii. NGO/SCC models developed/financed by government and INGOs (external funds);

iii. indigenous or self-emerged NGO/SCC models (internal funds);

iv. Grameen replications.

The Grameen Bank Model is a unique model implemented separately by both the government and local NGOs. Thus the Grameen model is an overlap of models (I) and (ii) above. Due to the volume of clients reached and its predominance in the microfinance field in Nepal, the Grameen Bank Model merits a separate discussion.

The following describes these four models including (I) the target market; (ii) methodology; and (iii) institutional viability. Throughout the discussion, various critical issues are raised, leading to proposed solutions addressed in Chapter 3.

2.3.1 Government-Mandated Models

The major government-mandated models (excluding the RRDBs) implemented through commercial banks and government line agencies include:

- the Intensive Banking Program (IBP) developed by NRB in 1974 mandating commercial banks (including joint venture banks and state-owned banks) to lend a percentage of their outstanding portfolios to priority sectors;
- the Small Farmers Development Program (SFDP) developed by the ADB/N in 1975 to meet the needs of small farmers and other rural poor;
- the Production Credit for Rural Women (PCRW) project implemented by the Women's Development Division (WDD) of the Ministry of Local Development (MLD) in 1984 with two public commercial banks (NBL and RBB) and UNICEF as their partners, specifically targeted to women.

[15] For the purposes of this study, any microfinance programs involving the government are referred to as government-*initiated*. Within government-initiated programs, some involve the government lending directly to the poor. These are referred to as government-*mandated* models.

Much has been written recently describing each of these programs, so they are not discussed in detail here. A brief summary of the programs is provided in Annex 1 - Review of Government Microfinance Initiatives. (For more detailed information, see the related literature in the Bibliography.)

Target Market

In general, government-mandated programs target small farmers and other low-income Nepalis. Any Nepalese national male or female with annual per capita income less then or equal to Rs. 2500 (US $45) and/or less than 0.5 hectare of land per family can borrow from SFDP. Similarly any male or female in IBP and female in PCRW with annual per capita income less than or equal to Rs. 2511 (US $45) can access credit services. While SFDP and IBP aim at improving the economic status of males and females below the poverty line, PCRW focuses specifically on improving access of rural women to formal credit facilities. The majority of SFDP loans are provided to men since land is required for collateral and women seldom own any land.

Government-mandated programs are active in most districts in Nepal. However, their outreach is limited. As of July 1996, about 286,000 households (189,061 under SFDP, 40,753 under PCRW, and 57,105 under IBP) were served by government-mandated programs (excluding Grameen Bikas Banks.)[16] SFDP covers all 75 districts and 652 VDCs in Nepal, while IBP covers 74 districts and 338 VDCs. PCRW covers 67 out of 75 districts and is active in 264 VDCs.

Methodology

The group lending approach is followed in SFDP, PCRW, and IBP wherein loans are provided to individual members based on a group guarantee, i.e. members of the group guarantee repayment of other member's loan in case of default. SFDP requires physical collateral in addition to the group guarantee while PCRW and IBP do not. Loan size is relatively large in government programs, ranging from Rs. 5,000 to a maximum of Rs. 50,000 per member. Loan appraisal is generally conducted by the group with final approval provided by bank staff.

Under government-mandated programs, loans are granted for one year or longer depending on the loan purpose. Interest rates on loans range between 14% and 18% calculated on the declining balance.[17] Interest rate subsidies are provided for loans under Rs. 5,000 (80%) and for loans under Rs. 15,000 (33%.) Repayment is based on the purpose of the loan, and to some extent the cash income patterns of borrowers. Compulsory savings are required in order to receive a loan. The current rate paid on savings is approximately eight percent.

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[16] Information provided by the NRB, Development Finance Division, as of July 1996.

[17] Interest calculated on the declining balance means that interest is charged only on the amount outstanding, taking into consideration the amount of principal repaid during the term of the loan. Interest can also be calculated on a "flat" basis where interest is charged on the initial amount of the loan regardless of the amount of principal repaid over the loan term. This results in a significantly higher amount of interest paid.

Institutional Viability

The success of government-mandated microfinance programs is limited. Repayment of loans is alarmingly low -- below 45% in the case of SFDP -- outreach is minimal (particularly in the Hills and Mountain areas), and delivery mechanisms are inefficient. Also, staff are poorly trained and often fail to ensure loan repayment. In particular, government line agency staff such as the WDOs of MLD have limited skills and experience in delivering financial services, even as “social intermediaries” who channel the persons but do not process the credit directly. As is often the case worldwide, loans made by the government or through government mandated programs are viewed as grants rather than a valuable credit service. The provision of subsidized interest rates further promotes the view of government loans as grants. Mandating commercial banks to provide small loans also poses difficulties, as these banks do not generally have delivery mechanisms in place to reach small borrowers.[18]

None of the government-mandated programs appear to be financially self-sufficient. Revenues are low and costs are high mainly due to substantial loan losses and inefficient management. The following table estimates revenue and expenses as a percentage of average outstanding loans of each of the government-mandated programs.

Table 2.1 Financial Viability of Government-Mandated Programs

	IBP	SFDP	PCRW
LENDING RATE	15.6%	16%	15.5%
Financing Costs	8.7%	10%	4%
Operating Costs	1%	16%	1.7%
Loan Losses	23.1%	23%	20%
TOTAL COSTS	32.8%	49%	25.7%
NET RESULT	**- 17.2%**	**- 33%**	**- 10.2%**

Source: Sharma, Shalik Ram, and Indira Koirala. “Microenterprises in Nepal: Dynamics, Prospects and Constraints” Visnu Nepal, June 1996.

[18] Note: IBP allows commercial banks to invest in equity of the RRDBs and/or provide wholesale funds to NGOs, recognizing their lack of delivery mechanisms to reach the poor.

The above table does not take into account the cost of maintaining the capital funds of these programs.[19] The Subsidy Dependency Index (SDI) developed by Jacob Yaron of the World Bank takes into account all costs for operating a microfinance program including the cost of capital funds. The SDI measures the degree of financial self-sufficiency of a microfinance institution. An SDI of zero indicates financial self-sufficiency. An SDI of 1 indicates that the current interest rate needs to be doubled to achieve self-sufficiency. Table 2.2 highlights findings of a World Bank study which calculated the SDIs and required onlending interest rates for the three government-mandated programs.

Table 2.2. Subsidy Dependency Index of IBP, SFDP and PCRW (1991/92)

	IBP	SFDP	PCRW
Subsidy Dependency Index	1.79	1.39	3.65
Average On-lending Interest Rate (%)	15.55	18.1	15.55
Required On-lending Interest Rate (%)	**43.5**	**42.5**	**72.4**

Source: World Bank (1993) "Sustainable Financial Services for the Poor: Building on Local Capacity, Volume II, Main Report" Country Operations Industry & Finance Division, South Asia Region.

The above two tables clearly indicate the inability of government-mandated programs to achieve financial sustainability.

In addition, financial reporting of government-mandated programs is generally poor, making it difficult to determine the true costs of implementing these programs. Major short-comings of the financial reporting systems include:

- poor system of recording loan losses (bad debt) and assessing portfolio quality
- no separate system of recording income and expenditures specific to the programs
- poor system of managing cash flow and inadequate attention to making effective use of available capital.

Microfinance programs mandated by the government will be institutionally viable only as long as donors and HMG are committed to provide continued subsidies. However, continued losses and the perpetuance of ineffective management are unlikely to lead the government to discontinue their support, as long as some clients are benefiting from the program. It is suggested that government-mandated microfinance programs would be more

[19] While the imputed cost of capital is not an actual cash outflow, it must be considered for long-term viability. Capital funds are often assumed to be "free" in that no interest is charged. At the very least, capital funds decrease in value in relation to inflation. With inflation at 10% per year, capital is reduced to zero over a ten year period (gross approximation) unless enough revenue is generated each year to maintain its value.

institutionally viable (and financially sustainable) if they were managed outside of the government.

2.3.2 NGO/SCC Models (External Funds)

There is a substantial number of NGOs and SCCs in Nepal providing microfinance services. They can be loosely divided into those which use external funds (provided by the government and/or INGOs), and those that use their own savings (internal funds.) The following discusses NGOs/SCCs that receive external funds.

Government Programs

There are three main government programs[20] which provide funds to NGOs and SCCs for the delivery of financial services:

- Rural Self-Reliance Fund (RSRF) established in 1990 and maintained by the NRB to provide funds to NGOs for onlending to microentrepreneurs.
- Micro Credit Project for Women (MCPW) funded by the Asian Development Bank aimed at developing a mechanism to use NGOs as credit agents to connect clients to commercial banks. The MCPW program is administered by WDD of MLD and was initiated in 1994 as an extension of PCRW, and is actually a hybrid since it uses NGOs to source clients, but the clients borrow directly from commercial banks as per the PCRW.
- Institutional Development Program (IDP) established in 1994 by ADB/N within SFDP; management of the savings and credit activities is handed over to small farmers organizations called Small Farmers Cooperative Ltd. (SFCL.) The SFCLs obtain wholesale funds from the ADB/N and provide retail credit to small farmers.

The operations of RSRF, MCPW and IDP are described in Annex 1 - Review of Government Microfinance Initiatives. For more information see related literature in Bibliography.

Target Market

The target market for these programs is similar to those of the government-mandated programs, particularly MCPW and IDP as they are extensions of PCRW and SFDP, respectively. MCPW is only available for women clients. The target market of NGOs/SCCs receiving funds from RSRF is the rural poor who own up to 0.5 ha. of land per family.

The outreach of these programs is limited due in part to the fact that they have only been in operation for a short period. In December 1996, 2965 women had been

[20] These programs differ from the first model - government-mandated models - in that they provide wholesale funds to NGOs/SCCs rather than lending directly to the poor.

reached by MCPW (CECI, interim report) in 12 districts and three urban centres of Nepal. RSRF works in 57 VDCs in 28 Districts, with 3194 clients and outstanding loans of 7.1 million as of February 1997. Loan overdues are 20%. The IDP works in 32 VDCs in 16 districts, with 10,260 clients and outstanding loans of 66.9 million as of February 1997. Their overdues are 41% of total outstanding loans. The latter two programs demonstrate by their overdue figures their limited viability.

International NGOs (INGOs)

INGOs actively supporting local NGOs/SCCs in the provision of microfinance activities[21] generally provide some or all of the following services:

- revolving funds for onlending
- grants to cover operating costs including staff and administration expenses, rent, and transportation
- matching funds whereby the INGO matches (or provides a multiple of) the amount of savings collected by the NGO/SCC from its members
- technical assistance including program development, group formation, staff and client training, and financial management.

Approximately 16 INGOs have programs in the area of microfinance. Three of these operate their micro-finance programs directly, promoting solidarity groups which they train in credit disbursement and savings mobilization, and then provide matching funds. Other INGOs work in collaboration with local and professional NGOs. Further details on operational areas are provided in the detailed Annex with location-specific data. Specific data on disbursement, repayments, outstandings, and amounts due is not available. However, generalizations are drawn from interviews held with all 16 organizations regarding markets, practices, and repayment rates.

Target Market

Many INGO-supported NGOs/SCCs focus on reaching the ‘poorest of the poor’ with financial services. In addition, many specifically target women, believing that the benefits of increased economic power will be greater for women since they are generally responsible for the health and education of their children and the welfare of the community itself. However, INGOs frequently combine the delivery of financial services with that of social services. This often results in lower rates of repayment, as the social services are usually delivered free of charge while financial services are not. Additionally, when the advisor and colleague becomes debt collector, it is more difficult for the NGO client to receive help if something goes wrong.

[21] Some INGOs operate their own microfinance programs often in conjunction with the delivery of other services such as literacy training, health and education.

Methodology

With both government programs and INGO-supported programs, the NGOs/SCCs are responsible for the delivery of financial services to clients. NGOs/SCCs use groups for lending and savings collection. Loan sizes from the NGO/SCC generally do not exceed Rs. 15,000 and no physical collateral is required. Instead, group guarantees are provided. NGOs/SCCs, with few exceptions, provide loans for relatively short terms, generally less than one year, with over half granting loans for less than six months. Loan appraisal is generally done by the group with some guidance from the staff. Interest rates on loans to end-borrowers are between 10% and 36%, with the higher rates charged by non-government funded programs. Borrowers of NGOs/SCCs are not eligible for government interest rate subsidies. Some INGO programs, particularly those providing microfinance as a minor activity, charge very low rates of interest, sometimes as low as 1%. Not surprisingly, repayment of these loans is very poor, as borrowers tend to view them as grants rather than loans.

Savings are usually compulsory and required on a weekly or monthly basis. For the most part, these savings cannot be withdrawn. This results in significantly higher effective rates on borrowing.[22] Interest rates paid on these savings range from 0% to 8%, with the majority paying 8%. However, since most savings cannot be withdrawn (with some exceptions after a number of years) the interest paid is simply added to the savings held.

Savings are often managed by the group itself, resulting in access to both 'internal loans' (those made from the group savings) and 'external loans' (those made by the NGO/SCC itself.) It is worth noting that interest rates on internal loans which are set by the group itself are often substantially higher than those on external loans, even within the same groups. This leads to two significant findings:

i. borrowers can pay higher rates of interest and do not require subsidized interest rates;

ii. "ownership" of funds greatly influences the interest rate set on loans and the repayment rates on such loans, contributing to financial sustainability.

Institutional Viability

Government programs supporting NGOs/SCCs are not financially sustainable. RSRF earns revenue of 8% on its loans to NGOs. Its operating costs as a percentage of outstanding loans are estimated at 6% and loan losses at 20.3% (there is no direct cost of funds to the government, as the funds are a budgetary allocation.) This results in a loss of at least 18.3%, making it currently financially unsustainable. The MCPW has just begun

[22] The effective rate on loans is calculated by including all financial costs including that of compulsory savings. If a loan of Rs 1000 requires 5% to be held as savings, the borrower actually only receives Rs 950 yet pays interest on and is responsible for repaying Rs 1000. Since she cannot withdraw these savings, each loan she takes becomes more expensive as her savings build up. Were she able to withdraw her savings, she would not need to borrow as much and thus would pay less interest.

disbursements, so no assessment can yet be made on its viability. However, the fact that the NGOs providing agent services are being directly paid by the donors, rather than receiving a payment of part of the spread from such lending from the commercial bank, indicates that when the donor stops paying, the NGO will stop providing the service.

The IDP is an offshoot of SFDP, with older sub-project offices being handed over to local communities. Under IDP, ADB/N provides a 4% margin to the sub-office to cover their administrative costs. Their performance is not believed to be better than the SFDP average to date. Loan losses are expected to decline with shareholder management at the local level. Administrative costs are already being significantly reduced with the replacement of ADB/N staff by local motivators. However, it is currently too early to determine the program viability.

It is difficult to determine the financial sustainability of INGO-supported programs, as few maintain sufficient records nor adequately measure loan losses. In addition, they often provide other services as well as financial intermediation and do not maintain separate records. Those receiving external assistance in the form of grants to cover overhead costs may not yet have reached financial sustainability. However, those which receive grants only for loan fund capital or as matching grants are generally able to cover their minimal costs and tend to only increase costs as their revenue increases. Thus they are considered financially viable in the short-term even if they receive capital funds. A significant unknown however is the degree of loan losses as most NGOs/SCCs fail to make provisions for loan losses or write-off loans. An additional unknown is the level of failure of such groups due to either lack of repayment or fraud.

The success of government and INGO-supported NGOs/SCCs providing microfinance services is greater than that of government-mandated programs which do not use NGOs/SCCs, in terms of outreach growth, repayment rates, and expected sustainability. Experience over the past five years indicate that NGOs/SCCs can deliver financial services at a cost much lower than the government itself and reach the intended target market. However, these programs still suffer from high loan losses and inefficient management.

2.3.3 Indigenous NGO/SCC Model (Internal Funds)

Several thousand indigenous savings and credit groups exist in Nepal, most of which have emerged over the last five years. They are generally small, unregistered organizations owned and managed by local village members. Decision-making is highly participatory and democratic.

Generally there is few or no paid staff and funds for onlending come primarily from the groups' savings.[23]

Target Market

Most indigenous NGOs/SCCs provide financial services within their villages to both men and women. Some NGOs/SCCs require their groups to be of one gender, but sometimes the total membership is both. Due to their small size and informal institutional structure, outreach of indigenous NGOs/SCCs is limited. The majority operate at ward/inter-ward/cluster level with very few operating at the VDC or inter-VDC level. They are concentrated in more accessible areas, and less so in remote areas. However some form of savings groups appear to exist in almost all areas; generally the more remote, the more informal in nature. All of the 36 municipalities have SCCs/NGOs with an average of at least 3 and over 25% of the VDCs in Nepal were estimated to have at least one such type of institution, based on the field surveys conducted by the team.

The average size of membership in surveyed local NGOs/SCCs[24] was estimated at 64 (minimum: 16 and maximum: 322) with 41 male (64%) and 23 female (36%.) The total number of households/members participating in such institutions has been estimated at 320,000. The proportion of members receiving credit is 32% (male 35% and female 26%) with a minimum of 4% and a maximum of 100%. The total number of households borrowing from NGOs/SCCs (excluding government-initiated programs) is estimated at 102,400 (71,680 men and 30,700 women.)

Methodology

Most indigenous NGOs/SCCs lend to individuals rather than to groups, and the size of loan is usually fixed relative to the amount of the members savings and/or a fixed ceiling. Where loan amounts are tied to members savings, the observed loan to savings ratio ranges from 0.8:1 to 10:1. Where general ceilings were set, the maximum amount ranged from Rs. 1,000 to Rs. 50,000. In indigenous NGOs/SCCs, loan approval is made by the governing body or the group as a whole. Processing of loan applications and delivery of credit is generally much faster in NGO/SCC models than in government-mandated programs (3 to 4 days vs. up to one year for government programs.) Interest rates on loans in indigenous NGO/SCCs tend to be much higher than other models, ranging between 18% and 36%. Reported repayment of loans is also very high, supporting the finding that member 'ownership' of funds is an integral part of successful loan recovery. Generally, the more indigenous the model, the better suited the credit and

[23] For further information on savings and credit groups, see "Community Based Savings and Credit Organizations in Nepal: Current Status and Future Prospects" a study conducted by the Canadian Centre for International Studies and Cooperation (CECI) funded by the Ford Foundation, January 1996.

[24] Local NGOs/SCCs surveyed were Bhojpur 16, Morang 9, Rautahat 8, Siraha 6, Sapteri 6, Udayapur 5, Gorkha 4, Newalparasi 1, Chitwan 1, Lamjung 3, Banke 2, Surkhet 1, Kailali 2 and Dadeldhura 9.)

savings services -- and hence the higher recovery rates-- are, since the services have been designed by the groups themselves to meet their needs.

Indigenous NGOs/SCCs are, by definition, financially sustainable since they utilize their own funds and cover their minimal operating costs. Most of the NGOs/SCCs have developed simple accounting and reporting systems to suit their requirements. A typical NGO/SCC reporting system includes a loan ledger, income and expenditure records, and some statement of assets and liabilities. Similar to the other models, indigenous NGOs/SCCs also do not record loan losses or adequately assess the quality of their loan portfolios. However, since they appear to have very high rates of repayment, this is less of an issue for indigenous NGOs/SCCs. Field survey results indicate that most NGOs/SCCs focus more on maintaining their operations or expanding the number of clients rather than improving their management systems such as record keeping, policy making, financial management, auditing, etc.

In spite of their ability to achieve financial sustainability, as indigenous NGOs/SCCs grow, their institutional viability becomes questionable due to following:

- Leadership crisis: The success of many NGOs/SCCs has been found to be attributable to the leadership provided by one or two committed, honest and voluntary members. There is lack of second tier leadership in most NGOs/SCCs, which may result in a lack of institutional viability if the leader(s) leave.
- Lack of the ability to hire full-time employee(s): Many NGOs/SCCs provide microfinance services using voluntary labor. Unlike other community development and social intermediation activities, microfinance services involve cash transactions on a regular and continuous basis. As these activities grow, it is unlikely that voluntary services will be sufficient, particularly in the light of the responsibility and accountability for managing cash.
- Lack of capital funds: The potential growth of many NGOs/SCCs is limited due to a lack of available funds for onlending. Savings generated by the members are often not sufficient to meet credit demand. Additional sources of capital funds are required. This could be achieved through the federation of NGOs/SCCs to take advantage of wholesale funding available from the commercial banks or government initiatives. However, at this point, federation of NGOs is not allowed and the federation of SCCs is limited to one federation per district and one national federation.
- Weak management system: NGOs/SCCs have been found to have very poor management systems particularly in terms of record keeping, policy making, financial management, auditing, etc. In addition, there appears to be a lack of planning to improve their management capabilities.
- Lack of basic physical facilities: Most NGOs/SCCs lack basic facilities such as office space, basic equipment and supplies, etc. required to implement their program and to expand with their clients.

If and when indigenous NGOs/SCCs expand their outreach, they may require external assistance and/or funding to ensure their viability in the long-term.

2.3.4 The Grameen Bank Model

This model was developed in Bangladesh and is being replicated in Nepal through two NGOs, Nirdhan and the Centre for Self-Help Development (CSD), and five government owned Regional Rural Development Banks (RRDBs), or Grameen Bikas Banks (GBBs.) Nirdhan was established in 1991 and began lending activities in January 1993. In January 1994, CSD initiated the Self-Help Banking Program implementing the Grameen model in five districts. Of the five RRDBs, one for each development district in Nepal, two were established towards the end of 1992, two more in 1995 and one in 1996.

The basic objective of these banks/NGOs is to improve access of women to formal credit for income-generating activities as a means to reduce their level of poverty. For a description of the Grameen Bank model, see Annex 1 - Review of Government Microfinance Initiatives.

Target Market

Grameen Bank replicators (GBR) target rural women from households with less than 0.6 ha. of land in the Terai and 0.5 ha. of land in the Hills. Geographical coverage of GBR is confined to 20 Terai and 4 Hill districts. About 52,000 women have accessed financial services through RRDBs and the NGO Grameens as of mid-December 1996. The Grameen replications in Nepal target women only, who have incomes of less than Rs 2,500 per year ($46), land of less than 1 acre for their household, and -- in the case of the NGO Grameens -- no persons with permanent jobs in the households. In Nirdhan's case, they also require that the homestead not be built of brick or sheet-metal roofing, indicating that there is additional outside income to the household.

Methodology

GBRs use groups for the delivery of financial services. They charge 20% interest on loans and pay 8% interest on savings (compulsory.) GBRs do not use the savings collected to fund their loan portfolio, preferring to borrow capital from the commercial banks at 6-8%. These rates are increasing, and the latest levels of borrowing from commercial banks have been at the same rates as for Treasury bills, about 11%, forcing Nirdhan to announce an interest increase to 25% to take effect in April 1997. Clients of RRDBs receive interest rate subsidies from the government (80% on loans less than Rs. 5,000; and 33% on loans less than Rs. 15,000.) Nirdhan draws the subsidies, but pays them in the form of social services such as trees for planting and latrines. As at December 1996, clients of CSD do not receive subsidies, creating an uneven market for credit services.

Institutional Viability

As of December 1996, the GBRs had recorded no loan losses. As a percentage of outstanding loans, operating costs are relatively high ranging from 10% for the Eastern

RRDB and CSD, to 61% for the new RRDBs.[25] With revenue of 20% and total costs between 19% and 30%, GBRs are much closer to reaching financial sustainability than other government-initiated programs. This is primarily due to their very high loan recovery rates.

Table 2.3 Financial Viability of Regional Rural Development Banks (ADD CSD AND NIRDHAN)

	RRDB - Far Western*	RRDB - Eastern*
LENDING RATE	20%	20%
Financing Costs	6%	6%
Operating Costs	23%	13%
Loan Losses	0%	0%
TOTAL COSTS	29%	19%
NET RESULT	**- 9%**	**+1%**

Source: Sharma, Shalik Ram, and Indira Koirala. "Microenterprises in Nepal: Dynamics, Prospects and Constraints", Visnu Nepal, June 1996.

The success of GBRs in Nepal is encouraging. Outreach appears to be growing and all are moving towards financial sustainability. However, GBRs are concentrated in the Terai regions. Due to the requirement of weekly meetings and loan repayments, it is unlikely that this model can be expanded to the Hill areas. In addition, government ownership of the RRDBs results in interest rate subsidies being made available to RRDB clients (and not CSD clients). Finally, there has been evidence of increasing political interference in terms of staffing and target areas, which will have a negative effect on viability and overall growth options.[26]

2.4 CRITICAL ISSUES

Based on the above analysis, this section summarizes problems faced by microfinance institutions in Nepal. From this summary, five critical issues have been identified that require policy changes on behalf of the government and donors, and management changes by the microfinance institutions. Proposed solutions to these critical

[25] Sharma, ram Shalik, Indira Koirala, "Microenterprises in Nepal: Dynamics, Prospects and Constraints," Visnu Nepal, submitted to the Asian Development Bank, Manila, June 1996.

[26] Financial sustainability, expansion and government ownership of the RRDBs is being addressed in a study conducted by Messrs. Peter Boone (SRI International) and Muzammel Huq (Grameen Bank Bangladesh) for IRIS/Nepal, to be published in early 1997.

issues are provided in the following chapter.

- The financial viability of microfinance institutions in Nepal is poor mainly due to substantial loan losses, and low interest rates charged on amounts disbursed. Revenue generated from the present volume of business in most programs is insufficient to cover their expenses, particularly for government-mandated programs and NGOs/SCCs promoted by INGOs that insist on a very low interest rate on loans. Loan losses experienced in government-initiated programs are significant, reducing the possibility of ever reaching financial viability.

- The use of repayment rates as an indicator of loan recovery is misleading. There is a lack of appropriate financial recording of loan losses and consideration of the true expense they represent. In addition, accrued interest on loans overstates the value of assets in a microfinance organization.

- With some exception in government-initiated programs including RRDBs, staff of microfinance institutions lack effective management skills, accounting practices and record keeping. Financial support may be required to provide technical assistance and training to these organizations.

- Government interest rate subsidies distort the market and result in unfair advantages for some microfinance institutions.

- Most lending of “internal funds” is done at significantly higher interest rates that loans made with “external funds.” In addition, repayment of internal loans is much higher than repayment of external loans, confirming the belief that member “ownership” of funds significantly influences the repayment of loans and the consequent financial viability of microfinance organizations.

- Most clients are unable to withdraw their savings, resulting in substantially higher effective rates on borrowing. In addition, the longer they continue borrowing, the more expensive the loans become as savings continue to build up, representing an ever increasing portion of the loan outstanding.

- The difficult geographic and economic circumstances in Nepal hinder the ability to increase outreach and volume of loans. Microfinance activities are mainly concentrated in accessible areas (lower Hills and the Terai.) Institutions find it difficult to expand their programs to inaccessible areas.

- Because there is often more than one microfinance organization operating in a specific area, some of which receive government subsidies and others that do not, there have been instances of “encroachment” or unfair competition between organizations. Some microfinance institutions, particularly those operating the government-initiated programs, have complained that other organizations are stealing their "worthy" borrowers and disseminating false information about other organizations. In addition, some borrowers are accessing credit from more than one organization, resulting in duplication of services and higher potential for losses.

- Short-comings in the legal and policy environment including the lack of an appropriate organizational structure for microfinance organizations; the inability to form apex organizations (federations); and the inability of unregistered organizations to access government funding result in problems for NGOs/SCCs active in microfinance.

- A lack of central lending facilities results in insufficient access to lending capital by some NGOs/SCCs, while others maintain excess funds with no investment opportunities. Further growth of most of the indigenous NGOs/SCCs has been limited due to a lack of capital funds and the small size of their membership.

- Many INGO-supported NGOs/SCCs lack a clear vision and mission to implement microfinance activities. A majority of these institutions have initiated savings and credit programs to meet their short-term needs or under the pressure of donor agencies including INGOs. Many lack a full understanding of the complexities involved in providing microfinance services leading to inefficient and unviable programs. These institutions use savings as a entry point while implementing community development projects. From these activities a significant amount of savings has been generated, yet very few INGOs have assisted these institutions to provide credit.

- Government-mandated programs are highly inefficient and suffer from substantial loan losses. They also appear in some cases to suffer from political interference in operations. Programs that provide wholesale funds to NGOs/SCCs appear to be more efficient and have the potential to be institutionally viable within a period of time.

3. Proposed Solutions

This chapter summarizes the issues in microfinance that were identified in the previous chapter into five critical issues and proposes solutions to these issues. The issues identified include:

1. financial viability of microfinance institutions including financial self-sufficiency, financial reporting and subsidies;
2. transformation of government programs from retail banking to wholesale banking;
3. expansion of the provision of financial services to the Hills;
4. encroachment or unfair competition between microfinance institutions;
5. federation of microfinance institutions.

3.1 FINANCIAL VIABILITY

Financial viability refers to the capacity of microfinance organizations to provide continued access to financial services in the long-term. In order to do this they must ensure the credit and savings services provided meet the needs of their clients and do so in a financially sustainable manner. To reach financial viability, effective financial management is required including: ensuring that there are enough capital funds to meet credit demand; generating adequate revenue to cover operating costs (financial self-sufficiency); and maintaining useful and accurate financial reports (financial reporting.) Continued reliance on subsidies impedes the ability of a microfinance organization to reach financial viability.

For the most part, microfinance organizations in Nepal have access to adequate capital funds. The main exceptions are the indigenous NGOs/SCCs and those organizations providing financial services in the more remote areas. The issue of capital funding will be addressed throughout this chapter, particularly in the discussion of critical issues (4) and (5.)

3.1.1 Financial Self-sufficiency

To be financially self-sufficient, a microfinance institution must generate enough revenue to cover all of its costs and earn enough excess revenue to increase its capital base (retained earnings) in order to provide services to a growing client base and/or clients with increased financial needs. It is important to differentiate between financial sustainability and financial self-sufficiency. Financial sustainability considers operating revenue (interest revenue, membership fees, investment income, etc.) and non-operating revenue including donations. If a microfinance institution is able to cover all of its costs with both operating and non-operating revenue, it is financially sustainable. However, to be financially self-sufficient, a microfinance institution must cover all of its costs with operating revenue only.

Expenses of microfinance organizations include (I) operating costs (salaries, office expenses, audit fees, overhead, transportation) (ii) financial costs (interest on deposits and external borrowings), (iii) loan losses and (iv) the cost of capital (inflation or the required return by the shareholders.)

The primary source of funds to cover these expenses is interest revenue generated by the loan portfolio.

At present, most microfinance institutions in Nepal are not financially self-sufficient. Exceptions include indigenous SCCs and some NGOs operating completely independently. Most indigenous NGOs/SCCs implementing microfinance programs benefit from voluntary labor and free office space (VDC office or someone's home), allowing interest revenue to be used to cover stationary expenses, transportation, postage, etc. They have not generally realized any loan losses (loan losses may have occurred but are not considered as costs.) However, the lack of loan loss provisions nor any consideration for the cost of capital funds suggests that most NGOs/SCCs may not be financially self-sufficient in the long term. Grameen Bank replicators have the potential to reach financial self-sufficiency, provided their loan losses remain minimal and they continue to improve efficiency and outreach.

The inability of microfinance institutions in Nepal to reach financial viability is primarily attributable to the following:

- Low interest rates on loans: the interest rate charged under government programs ranges between 13% and 18% with an average of 16%. These rates are insufficient to cover the cost of funds, loan losses and operating costs of these institutions and do not consider any cost of capital. Sustainable NGOs/SCCs charge rates between 18% and 36% based on their need to cover all of their costs.
- High loan losses: loan losses in the case of government programs are estimated to range between 20% to 50% of outstanding loans, with an average of 22% which is much too high to achieve financial self-sufficiency.
- Lack of well-trained staff: many microfinance organizations in Nepal lack sufficient staff-training programs. Inefficient management, lack of credit discipline and the combination of delivering social services with financial services result in inefficient operations and increased operating costs.
- Small client base: significant economies of scale are achieved when the number of clients is increased. Many microfinance programs do not have the required outreach to achieve financial self-sufficiency (due to lack of capital funds, inefficient delivery methods or poor service and product design.)

To achieve financial self-sufficiency, microfinance organizations must reduce their loan losses, develop more efficient operating procedures (delivery methods) and increase their outreach. In addition, interest rates should be increased to a level where they will cover all costs based on the most efficient delivery of services.[27]

Interest rates charged by most microfinance institutions (with the exception of Grameen Bank models and indigenous SCCs) are below existing market rates. Given the relatively small volume of loans (the revenue base), it is infeasible that a microfinance organization could cover its costs with below market rates. In fact, most successful microfinance institutions around the world charge significantly higher than market rates and are able to maintain significant outreach and sustainability. It is suggested that interest rates could be increased in Nepal without any loss of outreach.

[27] Note: during the initial stages in the development of a microfinance institution, costs will be greater than revenue. Clients should not be expected to pay interest rates high enough to cover these initial costs i.e. the first three to five years, nor should they be expected to cover the costs of inefficient operations.

The inability of many microfinance institutions to reduce their loan losses is partly attributable to a lack of credit discipline and a lack of "ownership" felt by clients. Clients that do not expect continued access to financial services often fail to repay their loans. This not only results in high loan losses, but also reduces interest revenue. Loan losses should be kept to a minimum of 2% in order to reach financial self-sufficiency. Loans from government programs are often viewed as grants rather than loans which need to be repaid. Programs where clients feel a sense of ownership, such as self-emerged NGOs/SCCs, generally achieve greater self-sufficiency than government or donor led programs.[28] This is particularly apparent in programs where both internally and externally funded loans are provided. Repayment of internal loans is virtually 100% while the same clients may not repay loans funded by external sources. In addition, internal loans are consistently lent at higher interest rates than external loans, indicating that clients are capable of paying higher rates.

Dedicated and qualified staff are also important factor in achieving self-sufficiency. Appropriate training, compensation and accountability are imperative to the success of microfinance organizations. Committed staff providing valued services which meet the needs of their clients is the best way to ensure self-sufficiency of microfinance organizations. There is a need in Nepal for greater commitment to a "business approach" to microfinance rather than a "social banking approach".

As the client base of a microfinance organization increases, financial self-sufficiency becomes easier to achieve as economies of scale are reached. However, the growth of a microfinance organization should be gradual, as the organization develops its products and delivery mechanisms to suit the clients. Sustained growth will only be achieved as microfinance organizations accurately assess the needs of the market and manage their activities accordingly. As microfinance organizations grow, they will require increased access to capital funding. With financial self-sufficiency comes increased access to capital sources through commercial banks[29], allowing for continued expansion of services.

3.1.2 Financial Reporting

In all microfinance organizations in Nepal, effective financial management is limited by a lack of trained staff to maintain or establish accurate reporting systems. This contributes to the inability to achieve and determine the financial sustainability of microfinance programs.

Existing financial reporting systems generally fail to accurately record the full costs of financial intermediation. While most microfinance organizations consider their

[28] Lynn Bennett et al, 1996.

[29] Commercial sources will lend to financially self-sufficient microfinance organizations as the risk is of non-payment is reduced in a self-sufficient organization.

operating and financial costs (including indigenous groups who pay a rate on the savings collected), the true cost of loan losses does not appear to be accurately calculated. This results in a (sometimes substantial) overstatement of the loan portfolios and understates the true cost of microfinance. Loans that have not been repaid for a significant amount of time should be removed (written off) from an organization's balance sheet, thereby accurately reflecting the amount of earning assets.[30]

[30] For further information on how to write off loans and develop accurate financial statements see Ledgerwood, Joanna. Financial Management Training - Finance, PACT Publications, New York. 1996.

In addition, many microfinance organizations accrue interest on overdue loans, resulting in an overstatement of their assets[31] and substantially distorting the financial position. Interest on overdue loans should not be accrued.

Current reporting tends to focus on cumulative amounts disbursed and repayment rates. Cumulative amounts disbursed provide no indication of the current volume of loans outstanding (and thus generating revenue.) Repayment rates do not adequately reflect the quality of the loan portfolio, and should not be used when reporting financial results.[32]

Finally, microfinance organizations in Nepal do not consider the cost of capital. At the very least, a cost equal to the rate of inflation should be applied to the equity of microfinance organizations to reflect the true cost of financial intermediation.

Improved financial reporting systems are required including:

- separate financial reporting (including Balance Sheets and Income Statements) for microfinance activities; revenue and expenses for all other activities should be maintained separately;
- operating revenue should be separated from non-operating revenue to determine the level of self-sufficiency;
- create and maintain portfolio reports including current loans outstanding and overdue amounts categorized by the amount of time the loan has been overdue;
- loan losses should be accurately recorded, including making provisions for loan losses (based on loan portfolio quality), loan loss reserves and periodic loan write-offs;
- repayment rates should not be used as an indicator of financial viability;
- interest on overdue loans should not be accrued; and
- the cost of capital should be considered.

3.1.3 Subsidies

[31] Interest accrued on overdue loans is recorded on the Income Statement and then *capitalized* (recorded on the Balance Sheet) as an asset.

[32] The use of repayment rates as indicators of successful financial intermediation is misleading and does not provide adequate information to determine loan losses. A more appropriate measure to use is the *arrears rate* or the *portfolio at risk rate*. The arrears rate measures the amount of payments that have become due and have not been received. The portfolio at risk rate measures the total balance of outstanding loans that have an amount in arrears. Both of these rates are generally stated as a percentage of current loans outstanding. When a microfinance organization determines its arrears rate or portfolio at risk rate, it is then able to calculate the amount of money that should be *provided* for to cover loan losses. This is referred to as the *Loan Loss Provision* and is entered as an expense on the Income Statement. The loan loss provision in turn is transferred to the Balance Sheet as a negative asset called the *Loan Loss Reserve*. The loan loss reserve reduces the outstanding loan portfolio, providing a more accurate record of revenue-generating loans. When a loan is written off, the loan loss reserve is reduced resulting in no effect to the net value of loans outstanding.

As is the case of many other developing countries, the microfinance sector in Nepal receives subsidies. Subsidies found in Nepal include: concessional interest rates on funds lent to microfinance programs (particularly government and INGO programs), subsidized interest rates to borrowers of government programs; grants provided to cover operating costs, technical assistance and training, social intermediation services,[33] and implicit subsidies in the acceptance of loan losses. These subsidies are provided by both HMG and international donors.

Despite the importance of self-sufficiency (and in fact as a means to achieving self-sufficiency) some subsidy is required, particularly in harsh socio-economic environments where the costs of financial intermediation are high. However, subsidies must be "timebound" and should only be utilized to develop (I) the capacity of microfinance organizations and (ii) the capacity of group members to assume the responsibilities of ownership.

To increase the capacity of microfinance organizations, subsidies should be provided to cover the following costs and only after careful review and consideration to organizations committed to reaching self-sufficiency:

- financial management training to ensure staff and management have a thorough understanding of the importance of accurate financial reporting and the ability to do so;
- training for effective financial intermediation including determining the target market and its needs, suitable product design, efficient delivery systems, effective policy, and appropriate management information systems;
- seed capital for onlending either as grants or loans with concessional interest rates;
- grants to cover shortfalls in operating revenue.

To increase the capacity of group members to assume the responsibilities of ownership, subsidies should be provided to cover the following:[34]

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[33] Social intermediation refers to creating social capital as a support to sustainable financial intermediation. Social intermediation bridges the gaps created by poverty, illiteracy, gender, and remoteness by building up the human resources and local institutions needed to prepare marginalized groups to manage their own institutions or enter into responsible business relationships with formal microfinance institutions. Ultimately, social intermediation develops the cohesiveness and self-management capacity of groups which enables them to bring down the costs of financial intermediation by reducing default through peer pressure and lowering the transaction costs banks incur in dealing with many small borrowers and savers. For further information on social intermediation, see Bennett, Lynn. "Building Sustainable Financial Intermediation Systems with the Poor" World Bank, Asia Region Gender and Poverty Team, May 1995.

[34] Bennett, Lynn. "Developing Sustainable Financial Systems for the Poor: Where Subsidies Can Help and Where They Can Hurt", Talking Notes, Agriculture and Natural Resources Agricultural Policies Division, The World Bank, Seminar on Rural Finance, May 26, 1993.

- to expand the outreach of social and production support services
- as "infant industry" investments to develop groups to the point where they can maintain their own relationship with formal financial institutions unaided

All subsidies should be designed to be phased out over a relatively short period of time, as the institutions reach self-sufficiency and/or the clients develop an ability to manage the program themselves.

Interest rate subsidies currently provided by the government to borrowers in government-initiated programs create an "un-level playing field" and should be discontinued. Subsidized interest rates have been proven to be ineffective in reaching the poor. The poor are generally insensitive to interest rates, preferring instead timely, efficient access to financial services. This has been clearly demonstrated in Nepal by the high interest rates charged on internal loans.

> "Where government subsidies are not justified is in supporting the price of financial services themselves. This form of subsidy perpetuates dependency on an already over-stretched government and on donors whose priorities may change; and inhibit the development of local institutions that are accountable to the target group and capable of becoming self-sufficient. In other words, although the default subsidy in these credit programs claims to help poor Nepalese men and women, it is actually the opposite of empowerment. It is charity instead of a business relationship. It fosters patronage relationships instead of relationships of mutual responsibility and accountability. Ultimately, the way to remove the aspect of dependency and to expand coverage to reach the vast numbers of poor men and women in Nepal and other countries who presently have no access to formal financial institutions is to show that institutions which serve the poor can also work as businesses -- that they can break even or possibly even make a profit."[35]

3.2 TRANSFORMATION OF GOVERNMENT PROGRAMS FROM RETAIL BANKING TO WHOLESALE BANKING

Government-mandated programs result in significant costs for the government and limited benefits for the poor. Loan losses are substantial, loan disbursement and collection are inefficient, loan sizes tend to be larger than those needed by the poor, and there is substantial political interference in the delivery of services. Microfinance organizations that are committed to financial self-sufficiency would be better positioned to design credit and savings products to meet their clients' needs, in turn reducing loan losses and ensuring continued access to financial services. Rather than lend directly to the poor, it is suggested that the government provide wholesale funding to existing sustainable microfinance organizations at market rates of interest. This would reduce administrative and delivery expenses, transfer accountability from the government to the microfinance

[35] Bennett, Lynn, Ibid, p.7.

organizations, and ensure the availability of capital funds. Most importantly, continued government involvement through a wholesale function would ensure capital is made available in the more remote areas, without the added costs of providing retail financial services in these areas. By providing such funds at market rates, the government will demonstrate to the private capital markets the profitability of wholesale lending, and the commercial banks and other such institutions can be expected to expand their participation over time.

It is suggested that the government organize district-level mechanisms to deliver funds to microfinance organizations (not government departments or line agencies) from a central financing facility. Management should have representatives from both the government and the private sector, in order to ensure effective operations and reduce political interference. In addition, HMG should establish a means of ensuring a portion of wholesale funds are provided to programs operating in the more remote areas of Nepal. Some cost-sharing may also be required in very remote areas.

HMG has already begun to transform some of its programs from retail lending to wholesale funding. The recent government initiative to move the lending activities from SFDP to local Small Farmers Cooperatives (SFCLs) is one such example. The experience of ADB/N indicates that SFCLs manage their operations more efficiently and effectively than other SFDP offices in the project districts. Also, banks participating in IBP are now able to wholesale funds to Grameen replicators or NGOs. This is of great benefit to the commercial banks, as they do not have the infrastructure set up to retail financial services to the poor.

3.3 EXPANSION OF MICROFINANCE SERVICES TO THE HILLS

Most microfinance organizations operate in the Terai or lower Hills areas. Expansion of microfinance services to the remote Hill areas poses significant problems.

People in the remote Hill and Mountain areas are poorer than those in the Terai and generally have lower savings capacities, lack basic facilities and must travel long distances to reach markets. This translates into smaller loan sizes, lower amounts of savings, and higher delivery costs. Any microfinance services must be designed with these factors in mind.

To provide microfinance services in the Hills, three issues must be addressed:

- the lack of capital for onlending;
- the need for social intermediation;
- the high cost of delivery relative to small loan amounts.

Due to the reduced savings capacity of the poor in the Hills, wholesale capital funds for onlending will likely have to be provided by the government and/or donors. Providing the repayment of loans is high and other costs are covered, this input of capital should only be required once in any given area.

INGOs and local NGOs are best suited to provide social intermediation services in the Hills but will necessarily require subsidies to do so.

The high cost of delivering credit and savings relative to the small volume of business will have to be addressed using an appropriate microfinance model. One of the most important factors in effectively delivering microfinance services is to minimize transaction costs. Due to the remoteness of the Hill areas, delivery of financial services should be designed to take advantage of existing local gathering areas such as kerosene and salt sellers, water pumps or other areas where community members must periodically visit. These areas can be used as the location for credit disbursement and collection (perhaps even utilizing the local seller as the bank officer.) Rather than periodic payments such as weekly or bi-monthly, repayment of loans and collection of savings should be matched to the cash flow pattern of the members and their frequency of visits to the area.

Depending on the capacity of the poor to pay high interest rates, subsidies may be required to cover operating revenue shortfalls for the microfinance organizations working in the area. Ultimately, these could be time-bound subsidies ending when the organizations reach self-sufficiency or when the groups are ready to take over management of the funds.

Of the four models identified in this paper, the most potentially suitable model for the remote Hill areas is the indigenous model. However, few indigenous groups appear to exist and those that do have no access to capital for onlending. The Grameen model as it is currently operated in the Terai is not appropriate for the Hills owing to the required frequency of meetings (weekly) and the inaccessibility of villages. Government-mandated models are not appropriate as a branch network does not exist in the remote areas (nor is it economically feasible to develop one.) The NGO/SCC model using external funds, however, provide some possibilities.

Variations on the existing NGO/SCC models may be appropriate for expanding financial services to the Hills. Three models are proposed here:

1. the **Village Banking Model** developed in Latin America;
2. the **Self-Reliant Village Banking Model** developed in Africa where population density is low (similar to the Hills); and
3. **Community Managed Revolving Loan Funds.**

3.3.1 Village Banking Model

Village banks are community-managed credit and savings associations established to provide access to financial services in rural areas, build a community self-help group, and help members accumulate savings.[36] The model was developed in the mid-80s by FINCA (Foundation for International Community Assistance.) Membership in a community bank usually ranges from 30 to 50 people, mostly women. Membership is based on self-selection. The bank is financed through internal mobilization of members' funds as well as through loans provided by an external agency (INGO/NGO or government.) Over time, the members' savings and share capital, and accumulated interest, is expected to grow enough to replace the external funding.

Methodology

A community bank consists of its membership and a management committee that receives training from the supporting external agency. The external agency lends seed capital (external account) to the bank which then on-lends the money to its members. All members sign the loan agreement to offer a collective guarantee. The loan amount to the Village Bank is based on an aggregate of all individual members' loan requests. Although the amount varies between countries, first loans are typically short-term (4 to 6 months) and in small amounts ($50), to be repaid in weekly installments. The amount of the second loan is determined by the savings a member has accumulated during the first loan period through weekly contributions. The methodology anticipates that the members will save a minimum of 20% of the loan amount per cycle (internal account.) Loans to the banks are generally provided in a series of fixed cycles, usually 10-12 months each, with lump-sum payments at the end of each cycle. Subsequent loan amounts are linked to the aggregate amount saved by individual bank members. Members work toward building sufficient savings to replace the external account at which point the external agency stops loaning to the bank and uses the funds to lend to a different community. Village banks have a high degree of democratic control and independence. Regular meetings are held, either weekly or monthly, to collect savings deposits, disburse loans, attend to administrative issues, and, if applicable to continue receiving training from the external agency.

Loan terms made to individual bank members, using the funds provided by the external agency through the loan to the bank, are usually identical to the terms of the group loan. However, loans from the internal account (member savings, interest earnings) are provided by the group members with generally shorter loan terms and higher interest rates. A maximum loan size is determined to prevent wealthier individuals from capturing most of the bank's capital.

Products

Savings: members savings tied to loan amounts; used to finance new loans or collective income-generating activities. No interest is paid on savings. However, members receive a share from the bank's re-lending or investment profits. The dividend distributed is directly

[36] Most of the information provided here originates from chapter 9 - The Village Bank Methodology - in Otero M., Rhyne E., "The New World of Microenterprise Finance."

proportional to the amount of savings each individual has contributed to the bank.
Loans: charge commercial rates of interest (1 to 3 % per month); higher rates if from internal account.
Training: some banks have broadened service delivery to include education components on agricultural innovations and education on nutrition and health.

Strong Points / Weak Points
+: reduced risk by joint repayment liability; increasing loan amounts as a member builds credit history and savings; simplicity of the financial mechanism; small amount of capital required; limited administrative overhead; decentralized management; access for illiterate members; participatory and builds on existing social structures.
-: loan levels tied to savings capacity (risk of excluding the poorest); financial sustainability often difficult to reach; lack of an intermediate-level institution necessary to provide access to capital or perform occasional supervisory duties; little ability to increase scale and to transform to a more formal institution; dependence on initial outside funding.

Significant examples
FINCA (Mexico, Costa Rica), Care (Guatemala), Save The Children (El Salvador), Freedom From Hunger (Thailand, Burkina Faso, Bolivia, Mali, Ghana), Catholic Relief Services (Thailand, Benin.) The original model has been adapted in a variety of ways. In FINCA Costa Rica, committee members take on the tasks of bank teller and manger. CRS works through local NGOs. FFH in West Africa work directly with credit unions in order to help them increase their membership amongst women. FFH clients graduate to the credit union.

For what clientele is this model most appropriate?

- Rural - sparsely populated but sufficiently cohesive;
- Women predominantly, but also adequate for men or mixed groups;
- Very-low incomes but with savings capacity.

3.3.2 Self-Reliant Village Banks

Self-reliant village banks are established and managed by a rural village community. They differ from Village Banks in that they cater to the needs of the village as a whole and not just a group of 30 to 50 people. This model was developed by a French NGO, the Center for International Development and Research (CIDR) in the mid 1980s.

Methodology
The supporting agency (INGO/NGO or government) identifies villages where social cohesion is strong and where the desire to set up a village bank is clearly expressed. The villagers - men and women together- determine the organization and rules of their bank and elect a management and credit committee and two or three managers. Self-reliant village banks mobilize savings and extend short-term loans to villagers on an individual basis. The sponsoring agency does not provide lines of credit - the bank must rely on its savings

mobilization.

After a year or two, the village banks build up a informal network or association where they discuss current issues and try to solve their difficulties. The association acts as an intermediary and negotiates lines of credit with local banks, usually an Agriculture Development Bank. The village banks are thus linked up to the formal financial sector. Because management is highly decentralized, central services are limited to internal control and auditing, specific training, and representation. These services are paid for by the village banks which guarantees the financial sustainability of the model.

Products
Savings: current accounts and term deposits.
Loans: short-term working-capital loans. No direct link between loan amounts and a member's savings capacity; interest rates are set by each village according to its experience with traditional savings and loans associations. The more remote the area, the higher the interest rate tends to be because the opportunity cost of money is high. Loans are paid in one installment. Collateral is necessary, but above all, it is village trust and social pressure that ensure high repayment rates.
Training: management committees, managers and members all receive extensive training. Some programs also provide technical assistance to microentrepreneurs who are starting up a business.

Strong Points / Weak Points
+: strong participation of villagers (men and women) in decision-making and management; impact on organization of other village activities; high repayment rates based on peer pressure at the village level; strong mobilization of savings and linkage with formal financial sector guarantee independence from donors;
-: financial sustainability may be difficult to reach in more remote areas; central structure too weak to provide a full range of services to the banks.

Significant examples
Caisses Villageoises d'Epargne et de Crédit Autogérées (CVECA) in Mali, (Pays Dogon), Burkina Faso, Madagascar, Gambia (VISACA), Sao Tome, Cameroon, Benin (CBDIBA) and the Gambia.

For what clientele is this model most appropriate?
- Rural areas, men and women;
- Low income to medium with some savings capacity.

3.3.3 Community Managed Revolving Loan Funds

A community-managed revolving loan fund (CMRLF) is an informal mutual finance group, typically consisting of between 30 and 100 members, often women. The CMRLF acts as a mini-bank, mobilizing and managing its own funds, and expected to become independent from the formal lending institution. Members are required to save, but funds are also provided from an outside source, either in the form of loans or grants.

Methodology

The loan is made to groups, each comprised of 30 to 100 members. Credit officers can work with 10 or more groups, thus working with up to 1,000 clients. Contact with clients is in group meetings. Credit officers process and approve group loan request, through verification of the groups' records and bookkeeping system, based primarily on the officer's assessment of the group's management capabilities and cohesion. Individual loans are approved by the group, usually through an elected management committee. Borrowers do not need to have existing businesses. Staff and board are hired and elected respectively and agree to a regular schedule of visits and a plan for technical assistance.

The amount of the loan is based on an initial equity contribution by group members and is usually in multiples of 2:1 or 3:1. Funds may be provided through grants rather than loans. If they are provided as loans, loan terms are a minimum of 2 years and commercial rates are usually charged. Individual loan terms and amounts vary and interest is usually significantly higher than commercial rates. Collateral is often required and compulsory initial savings deposits are collected. Ongoing savings contributions are not required. The groups internal capital is build up primarily through interest.

Products

<u>Loans</u>: group loans are based on equity; individual loan terms vary; commercial interest rates or higher; loan approval is completed by group management.
<u>Training</u>: provided to staff and board by external source; some training and technical assistance may be provided to clients.

Strong Points / Weak Points

+: high degree of autonomy; community builds up own capital base; empowering experience for poor people with no credit or business experience.
-: responsibility for group repayment of loan; meeting attendance is time-consuming; responsibility for fund management

Significant examples

First People's Fund (Canada).

For what clientele is this model most appropriate?

- rural areas where population is sufficiently cohesive**;**
- women**;**
- focus on agriculture-related activities..

Which partner institution can be a good implementing agency for these models?

<u>Local NGOs and international NGOs</u> are most appropriate because they have the ability to work at a grassroots level. <u>Development and commercial banks</u> can be adequate

implementing agencies if they adopt participatory methods. Government agencies can also be called upon as loan management is decentralized at the group level, and program officers mostly participate in training and guidance, and not as loan officers.

Each of the above models may be appropriate for the Hills of Nepal. However, all require external support either in the form of training, management, and/or capital funds. This implies a necessary commitment from HMG and international donors to support these efforts, particularly in the formation stages.

3.4 ENCROACHMENT OR UNFAIR COMPETITION

Encroachment is defined as the attempt by one microfinance organization to capture borrowers from, or disseminate false information about, another microfinance organization. Information gathered during the field surveys indicate that encroachment is for the most part, not a significant problem. However, in some areas where government-initiated programs operate, particularly those whose clients received subsidized interest rates, there has been some duplication of services. This is most common in the most accessible areas of the Terai where numerous microfinance organizations are operating. It is further exacerbated by political interference encouraging the disbursement of loans to people who may not be the appropriate clients for the services being offered.

It has been suggested that a central body be formed to designate specific areas to specific microfinance organizations in order to reduce the problems of encroachment. The authors believe

that this would not be an appropriate solution. Of particular concern is the fact that government interest rate subsidies only exist for some programs.

In any given area, there is a range of microfinance clients requiring varying products and services. Most specifically, loan sizes will vary depending on the borrowers' activity and their level of income. The demand for financial services amongst the poor is substantial, providing a significant number of clients for all microfinance organizations. Provided microfinance institutions clearly identify the target markets and design their products and services accordingly, allowing clients to freely choose the best provider, there should be no encroachment problems. This however, requires a marketplace which is free of government subsidies and other imperfect conditions. Since this is not the case in Nepal, some measures are required.

To reduce the problems of encroachment and unfair competition, the following is suggested:

- develop a means of information sharing amongst microfinance institutions whereby lists of clients/members of each program are provided to other programs;
- allow organizations to determine their most appropriate target market (as defined

by their objectives) and the corresponding products and services;

- eliminate government interest rate subsidies for borrowers.

3.5 LACK OF APPROPRIATE INSTITUTIONAL STRUCTURE AND INABILITY TO FORM A FEDERATION

Institutional Structure

No specific act exists for an appropriate institutional structure for organizations providing microfinance. This results in legal issues (liability of members and the inability to legally collect savings), supervision difficulties and ownership problems.[37] For microfinance organizations operating outside of the government programs,[38] they either register as NGOs, Cooperatives (SCCs) or remain unregistered.

Non-Governmental Organizations (NGOs)

NGOs are required to register under the Society Act (1978) at the local District Development Offices and renew their registration annually. To register, NGOs must have a minimum of seven members, be non-profit in nature, provide external audits annually and refrain from engaging in commercial activities. NGOs can provide credit and savings services if stated in the Memorandum or Association. NGOs cannot raise funds by issuing debentures or bonds.

NGO members are not legal owners and do not incur any liability. In the event of liquidation, all assets are taken over by the government.

The NRB has made a provision for NGOs specifically engaged in microfinance activities whereby they can register with NRB and engage in specific "banking" functions. As of December 1996, 22 NGOs had registered with the NRB, qualifying them to receive IBP funds from the commercial banks.

Cooperatives (SCCs)

Cooperatives must register under the Cooperative Societies Act (1992) by submitting an application to the Registrar of Cooperative Department with two sets of by-laws, a work-plan, and the number of shares each member has agreed to buy. They must have a minimum of 25 members, adhere to the Cooperative Societies Rules (1993) and NRB directives, maintain a reserve fund, and provide both internal and external audits. Cooperatives can record profits and distribute dividends to their members as well as

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[37] A study is being conducted by IRIS/Nepal with regard to the legal and regulatory framework for microfinance organizations in Nepal which will address these issues. Release is expected in early Spring 1997.

[38] Government programs are governed by either the laws of ADB/N or the Commercial Banking Act.

engage in commercial activities. Ownership of the cooperative is with its members and they incur limited liability. Election of a Board of Directors is compulsory with each member receiving one vote. To become a member, share(s) must be purchased. An annual general meeting must be called within six months of the end of the fiscal year. Upon liquidation, all assets, net of liabilities are transferred to another cooperative or the district union or national federation.

As a general rule any registered cooperatives must receive permission from the NRB to undertake banking transactions. However, cooperatives registered with NRB are not eligible for IBP funds from the commercial banks.

Both NGOs and SCCs have limitations when engaging in microfinance activities. NGOs are not allowed to collect savings and cannot form apex organizations or federations. SCCs cannot accept deposits or make loans to non-members and cannot form more than one federation at the district and national levels. For an organization to register as a bank, significant capital is required both as an initial investment and based on the perceived 'high risk' of their loan portfolios. Bank reporting requirements often exceed the capacity of small microfinance organizations. In addition, the Central Bank is not able to supervise a large number of small organizations.

An institutional structure appropriate for the delivery of financial services is required in Nepal recognizing the needs of microfinance organizations. This issue is currently being addressed in many countries with the majority developing some form of self-regulation with minimal supervision by the State. This issue goes beyond the scope of this paper and requires further study.

3.5.1 Federation

Under existing legislation, there is no mechanism for NGOs, solidarity groups and local community based organizations providing credit and savings services to federate. SCCs are only able to form one federation per district and one national federation. In addition, many SCCs at the district level have found federation to be problematic due to a lack of information, procedural complexities and legal restrictions.

The Cooperative Societies Act currently provides for only one national level Cooperative Federation and one in each district. This limits the effectiveness of the federations and indirectly grants monopoly to the first established federation, which may not be able to serve the needs of its affiliated district or primary level unions/societies.

Currently, the national cooperative federation is the Nepal Federation of Savings and Credit Cooperative Unions (NEFSCUN.) As of December 1996, there were 199 cooperatives registered with NEFSCUN and seven district federations (Kathmandu, Lalitpur, Bhaktapur, Gorkha, Rautahat, Morang and Bardia.) NEFSCUN objectives are to help promote, establish and strengthen self-managed savings and credit groups; support, organize and conduct various types of training, education campaigns, seminars, and workshops; and to provide linkages between the savings and credit union movement and other line agencies.[39] (In the past, NEFSCUN was politicized, and this has influenced its ability to foster expansion, effective repayments, and national-level cooperation.) The purpose of the district federations is to bring the services of an apex organization such as training and development closer to the primary level SCCs than is possible with a national apex. To date, these district unions have been relatively inactive and have not provided significant services to the member SCCs.

On December 14, 1996, the NEFSCUN Board of Directors approved the establishment of an inter-lending Central Finance Facility. NEFSCUN will borrow funds from the commercial banks at 6% interest and onlend funds to its members at 15%. This will likely be of great benefit to those SCCs that cannot access capital funds on their own.

The ability of microfinance institutions to form additional federations would allow: the pooling of resources; exchange of information; economies of scale with regard to delivery of training and technical assistance as well as other services; wholesale commercial borrowings; and access to a central financing facility.

> "They (federations) perform an active financial intermediation function, particularly mediating flows from urban and semi-urban to rural areas and between net savers and net borrowers, while ensuring that loan resources remain in the communities from which the savings were mobilized."[40]

A regulatory framework needs to be established to allow any number of federations of each of these groups taking into account their different approaches, maturity and target markets.

4. Recommendations

Based on the previous assessment of the critical issues in microfinance in Nepal, this chapter provides recommendations to the government of Nepal, the donor community, and microfinance organizations themselves.

4.1 RECOMMENDATIONS TO GOVERNMENT

[39] "Nepal Federation of Savings and Credit Cooperative Unions Limited" Kathmandu, Nepal, 1988.

[40] Magill, John H. "Chapter 8, Credit Unions: A Formal-Sector Alternative for Financing Microenterprise Development" in The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor, Otero and Rhyne, eds.

- eliminate interest rate subsidies on loans under Rs. 5,000 and Rs. 15,000;
- provide subsidies for capacity building of microfinance organizations and for social intermediation services to develop group capacity;
- ensure capital is available for lending in the remote areas; consider means of providing incentives to microfinance organizations operating in the remote areas including capital loans and cost-sharing schemes;
- foster at the VDC level an information system providing names of borrowers or villages receiving loans;
- create an appropriate institutional structure for microfinance organizations;
- reform the existing legal framework to allow SCCs to register more freely and form more than one federation at the district and national levels;
- focus IBP mandates on wholesale lending;
- focus on wholesale lending rather than retail lending, and provide wholesale funds only to financial institutions, not government departments or line agencies.

4.2 RECOMMENDATIONS TO DONORS[41]

- support microfinance organizations that are focused on providing services to women;
- provide support only to microfinance organizations that are professional and committed towards achieving institutional viability;

[41] For specific recommendations for USAID/Nepal, including a Terms of Reference and budget, see Annex 3.

- provide standard and uniform reporting requirements[42] that are effective for financial management and of use to the management of the microfinance institutions themselves;[43]
- require reporting that is separated by function ensuring that microfinance activities are reported separately;
- encourage microfinance institutions to charge interest rates sufficient to cover their costs, while ensuring that these costs are as low as possible;
- support development and delivery of standardized training programs for the staff and management of microfinance institutions, including financial management training, human resource management; productivity and efficiency training and product development training;
- encourage he development of NGOs/SCCs providing financial services in the Hills including financial and institutional support;
- support ownership transfer of all government microfinance programs, and the transformation from retail lending to wholesale lending;
- support the development of a central financing facility for NGOs/SCCs;
- support changes required to allow SCCs to form more than one federation and provide guidance on the development of an appropriate institutional structure for microfinance organizations; and
- support the development of an integrated financial system by encouraging commercial banks and other institutions to wholesale lend to deserving microfinance institutions, rather than crowding them out with donor funding for this purpose.

4.3 RECOMMENDATIONS TO MICROFINANCE INSTITUTIONS

- define target markets clearly and design products and services to meet clients' needs, cash patterns, etc.;
- focus on the provision of financial services only and do not mix social welfare services with the delivery of financial services;
- while operating as efficiently as possible, charge interest rates high enough to cover all costs;
- improve financial reporting practices; ensure adequate loan loss provisions and periodic loan write-offs; do not accrue interest on loans that are overdue; prepare accurate Balance Sheets, Income Statements and Portfolio Reports;

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[42] The Consultative Group to Assist the Poorest (CGAP) is currently developing standard reporting requirements for microfinance organizations. These will be delivered in March 1997.

[43] See "Micro and Small Enterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries," Committee of Donor Agencies for Small Enterprise Development; Donors Working Group on Financial Sector Development, October 1995, and "Microenterprise Institutions in Nepal: Opportunities for USAID Involvement," submitted to USAID/Nepal by Peters et al.,1995.

- measure performance based on loan quality and cost recovery, not on repayment rates and cumulative loans disbursed;
- consider the cost of capital when determining financial sustainability.

Annex 1 - Review of Government Microfinance Initiatives

1.1 The Grameen Bank Model

The Grameen Bank model targets rural women from households with less than 0.6 hectare (the Terai) or 0.5 hectare (the Hills) of land. Peer groups of 5 members are self-formed (members must be unrelated) and incorporated into village “centres” of up to eight peer groups. Attendance at weekly meetings and weekly savings contributions, group fund contributions and insurance payments are mandatory. Savings must be contributed for 4 to 8 weeks prior to receiving a loan and must continue for the duration of the loan term. (CSD also provides voluntary savings services.) Interest of 8% is paid on savings. Group members mutually guarantee each others loans and are held legally responsible for repayment by other members. No further loans are available if all members do not repay. No collateral is required. Mandatory weekly meetings include self-esteem building activities and discipline enforcement. When loans are disbursed, 5% of the loan amount is withheld as a group fund. The group fund is managed by the group and may be lent internally to group members.

Loans are made to individuals within the group by the local credit officer at the weekly meetings. However, only two members receive loans initially. After a period of successful repayment (between four and eight weeks), two more members receive loans. The final member receives her loan after another period of successful repayment. Loan amounts vary from Rs. 3,000 to Rs. 20,000 and carry an interest rate of 20% per annum. Loan terms are for one year with 50 weekly payments of Rs. 22 per Rs. 1,000 borrowed. Interest subsidies of 80% on loans up to Rs. 5,000 and 33% on loans up to Rs. 15,000 are received by the clients at the end of the loan term providing they repay the loans on time.[44] Note: these subsidies are received only by the five RRDBs and by Nirdhan, resulting in an unfair disadvantage for clients of CSD. CSD has applied to receive the subsidies and is currently being considered.[45]

Grameen typically provides pre-credit orientation, but minimal technical assistance to clients. Loan appraisal is performed by group members and centre leaders. Branch staff verify information and make periodic visits to client businesses. Credit officers usually carry between 200 and 300 clients.

1.2 Intensive Banking Program

In light of the very limited share (less than 1% of total credit disbursed) of

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[44] Note: subsidies have not yet been announced for 1996.

[45] Comment by Shalik Ram Sharma, Chief Manager, Nepal Rastra Bank, during interview on December 27, 1996.

commercial banks in agricultural credit and the predominance of agriculture and rural sectors in the economy, the central bank (NRB) directed the two government commercial banks in 1974 to invest at least 5% of their total deposits in the `small sector' (agriculture, cottage industries and services) to increase the flow of credit towards small farmers and small businesses. This scheme was known as `Small Sector Supervised Credit' which was renamed `Priority Sector Credit" in 1976 and the mandate was increased to 7% of deposits. In 1981, the Priority Sector Credit program was again renamed as the `Intensive Banking Program (IBP)' and the required investment was increased to 10% of deposits and then changed to 8% of total loan portfolio.

In 1986, the required investment by commercial banks was increased to 12% of their loanable funds to government-designated priority sectors. All commercial banks are required to meet the Intensive Banking Program mandate. Within the 12%, 3% for the two government commercial banks, and 2.5% for the other commercial banks, is required to be invested in the deprived sector. Loans of less than Rs. 15,000 meet the deprived sector requirements. All households are eligible for priority sector loans, however, sixty percent of the loans must be targeted to families below the poverty line, defined as those having per capita incomes of less than Rs. 2,511.

Banks that do not meet the mandated volume of investment in priority sectors are required to deposit the shortfall with the Central Bank and to pay a penalty to the Central Bank equal to their highest lending rate of interest (generally 23% - 26%) on the shortfall. Alternatively, banks can make an equity investment in the government RRDBs; lend wholesale funds to NGOs/SCCs/RRDBs; or fund private sector companies to onlend to producers. Interest rates on loans range from 15% to 18% to clients, 6% to 11% to NGOs and the RRDBs.

1.3 Small Farmers Development Program

The Small Farmers Development Program (SFDP) is an ADB/N-managed program developed in 1975 with the support of the FAO, UNDP and the Asian Development Bank. Its objective is to “augment the overall well being of the low income small farmers and landless laborers by providing them with inputs such as credit and basic resource activities.”[46] Groups are formed of small farmers, tenants, share-croppers, fisherman, landless laborers and disadvantaged people of 5 to 10 members whose annual per capital income does not exceed Rs. 2500 and/or own less than 0.5 hectares of cultivated land per family. Once groups are formed, the Group Organizer (GO) employed by the Bank helps groups devise an activity or investment plan; assist in the implementation of income-generating or social programs; integrates group members with the outreach of various line agencies; and sponsors and utilizes “action based research.” Income-generating activities (arable crops, horticulture, livestock, farm mechanization and irrigation, marketing and cottage and rural industry and commerce) are undertaken individually but credit is

[46] “Small Farmers Development Programme in a Nutshell” Published by the Small Farmers Development Centre, Agricultural Development Bank, Nepal, March 1996.

obtained through the group.[47] Group savings are collected and managed by each group and are lent within the group for emergency or social purposes.

Average loan sizes for individuals within the groups range between Rs. 8,000 and Rs. 30,000. Interest on loans is between 14% and 18%. Repayment rates are significantly poor at about 50% in 1996 (an increase from 36% in 1989.)

Other SFDP activities include social and community development, community irrigation, environmental conservation, women's development, training, and institutional development.

1.4 Production Credit for Rural Women

The Production Credit for Rural Women program (PCRW) was developed in 1982 with funding and technical assistance from UNICEF. It is currently implemented by the Ministry of Local Development (MLD) through the Women's Development Division (WDD) in association with NBL, RBB and ADB/N. Funds are provided by the commercial banks under the Intensive Banking Program (as a means to ensuring that some of the IBP funds go to women) and IFAD.

[47] Von Pischke, J.D., Lynn Bennett, Mike Goldberg. "Sustainable Financial Services for the Poor: Building on Local Capacity" Volume 1: Main Report, The World Bank, October 12, 1993.

The main objectives of PCRW are to improve the social and economic position of women through the provision of credit, extension services, drinking water, health and various time and labor savings technologies and skills.[48] Credit is provided through groups of four to ten which are formed by staff of the WDD. Maximum loan size is Rs. 30,000 and are provided by the commercial banks at an interest rate ranging between 13% to 14%. Subsidies on loans of less than Rs. 5,000 (80%) and less than Rs. 15,000 (33%) are provided.

The NRB has advised that following the termination of funding by IFAD, this program will wind down as of June 1997.

1.5 Rural Self-Reliance Fund

The Rural Self-Reliance Fund (RSRF) was established in 1990 by the NRB to provide funds to assist NGOs/SCCs in their microfinance activities. RSRF lends to NGOs/SCCs who in turn on-lend to clients. Under this program, NGOs/SCCs play the role of financial intermediaries.

The objective of the Fund is to provide financial assistance to the deprived sector (rural poor who own up to 0.5 ha. of land) for carrying out income generating activities using their own labor, skill and other local resources. Funds for the RSRF are provided through a budgetary allocation of HMG. Rs. 10 million was allocated in 1991/92 fiscal year and another Rs. 10 million in the following fiscal year.

[48] "An Introduction to Women Development Programme," Women Development Division, Ministry of Local Development, Nepal, 1996.

NGOs/SCCs are responsible for identifying the geographical working areas and target clients, organizing the clients into groups and motivating them to save on regular basis. Once the groups have been successfully formed and have saved regularly for a minimum period of six months (amount determined by group), the NGOs/SCCs approach RSRF with an investment plan and program for additional financial resources, not to exceed 15 times the total savings generated by the group (up to a maximum of Rs. 500,000.) No collateral is required. Funds are lent to the NGOs/SCCs for a period of 3 years at an interest rate of 8% per annum including a six-month grace period. If the NGO/SCC repays the loan to RSRF on time, a 75% interest grant is provided to cover administrative costs.[49]

By December 1996, RSRF had extended financial services to over 3,000 families of 25 districts through 49 NGOs/SCCs. Total loans outstanding as of December 1996 was Rs. 6 million. Overdue loans constituted 25.4 percent of the outstanding loan portfolio.

1.6 Micro-Credit Project for Women

The Micro-Credit Project for Women (MCPW) began in 1994 funded by the Asian Development Bank in association with NBL and RBB. The objective of MCPW is to improve the socio-economic status of women through the provision of credit and savings using NGOs as financial intermediaries. The project consists of three activities: the formation of groups and training; institutional support of NGOs; and the provision of credit and savings services. MCPW is administered by WDD of MLD with the support of an NGO Support Unit, namely the Canadian Centre for International Studies (CECI.) Loanable funds are provided by the two banks.

The field staff of WDD and/or the NGOs provide social intermediation services including social preparation, group formation, skills training, saving mobilization, loan collection, loan appraisal, recommendation of viable loan proposals to participating banks, supervision and follow-up. The participating banks are responsible for disbursement and recovery of loans.

Plans are under way for a new Act to be promulgated to register NGOs to receive donor funds and on-lend them directly under specific circumstances, thus removing the need to go directly to participating commercial banks, and making such NGOs direct financial intermediaries.

1.7 Institutional Development Program

[49] Sharma, ram Shalik, Indira Koirala, "Microenterprises in Nepal: Dynamics, Prospects and Constraints," Visnu Nepal, submitted to the Asian Development Bank, Manila, June 1996.

The Institutional Development Program was created by the ADB/N as a means of transferring the management of SFDP to its savings and credit groups. Small Farmers Cooperatives Limited are formed from the SFDP groups and play the role of financial intermediaries between ADB/N and the smaller farmers. SFCLs access wholesale credit from ADB/N and provide retail credit to the small farmers through groups and to individuals.

An SFCL is set up with a Main Committee at the VDC level, Inter-Groups at the Ward level and groups of farmers at the community level. The Main Committee is responsible for management of the organization, monitoring and follow-up, co-ordination with government line agencies and accessing wholesale loans. The Inter-Groups make credit recommendations, collect savings and disburse loans, and implement social activities. The groups of farmers identify group activities, collect savings, recommend loans and implement social activities.

As of December 1996, 31 SFCLs had been formed and 16 more were in progress. Plans are to transfer all SFDP groups to SFCLs within five to seven years.